106

H.R. 10—THE FINANCIAL SERVICES MODERNIZATION ACT OF 1999

HEARINGS

BEFORE THE

COMMITTEE ON BANKING AND FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED SIXTH CONGRESS

FIRST SESSION

FEBRUARY 10, 11, 12, 1999

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ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

H.R. 10—THE FINANCIAL SERVICES MODERNIZATION ACT OF 1999

WEDNESDAY, FEBRUARY 10, 1999

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON BANKING AND FINANCIAL SERVICES,
Washington, DC.

The committee met, pursuant to call, at 10:00 a.m., in room 2128, Rayburn House Office Building, Hon. James A. Leach, [chairman of the committee], presiding.

Present: Chairman Leach; Representatives McCollum, Roukema, Baker, Lazio, Royce, Metcalf, Ney, Barr, Kelly, Paul, Weldon, Ryun, Hill, Manzullo, Ryan, Ose, Sweeney, Biggert, Terry, Green, Toomey, LaFalce, Vento, Frank, Kanjorski, Waters, Watt, Bentsen, J. Maloney of Connecticut, Hooley, Weygand, Sherman, Lee, Mascara, Inslee, Schakowsky, Moore, Gonzalez, Jones, and Capuano.

Chairman LEACH. The hearing will come to order. Today we begin the first of three days of public hearings on legislation to modernize our Nation's archaic, Depression-era banking laws which were long ago overtaken by market developments. This is, as everyone here knows, an issue which has been under consideration in Congress for several decades. Last fall we came close to achieving consensus and the bill before us reflects compromises hammered out over four years of consideration.

Today we are starting off these hearings with broader support for the legislation than has ever existed before. An impressive number of large and small commercial banks, regional and money center securities firms, insurance companies and agents support the approach on the table.

The bill before us was introduced by myself, Vice Chairman McCollum, the chairs of all of our subcommittees and other Members. A bill with similar goals will apparently be introduced later today by Mr. LaFalce, which reportedly will largely have Administration support. I consider this to be a constructive addition to the policy dialogue.

Thus, I hope we are in the final lap in winning congressional approval of financial services modernization.

In conclusion, let me stress that if we fail to move on legislation of this nature, American international preeminence in financial markets will come into question, the American consumers will be denied the benefits which would flow from greater competition within the financial arena, and many rural areas will be precluded access to a broad range of financial products. Here, let me remind everyone that two years ago Treasury Secretary Rubin estimated

the consumers could save an estimated $15 billion annually as a result of passage of modernization legislation.

In the interest of time to hear from our distinguished witnesses, I will recognize Mr. LaFalce for an opening statement. Following Mr. LaFalce, I will recognize the Chairman and the Ranking Member of the two subcommittees with primary jurisdiction.

John, you are recognized.

Mr. LAFALCE. Thank you very much, Mr. Chairman. First I would like to commend you personally and your efforts to move forward expeditiously on this very important issue of financial modernization. This is something that I have pursued the entirety of my tenure in Congress, and that is over two decades now, and it has eluded us. And I hope it will not elude us this Congress. I hope we will pass it this year.

As a result of the deliberations of the last Congress, most especially in the Senate, consensus emerged regarding many of the central components of viable modern legislation, and you have introduced legislation which in large part reflected that consensus. However, I do have some doubts whether the best vehicle at the end of the last session is the most appropriate vehicle for beginning what will necessarily be a new process involving new players and possibly new issues.

As a result, this afternoon I will be introducing legislation along with Financial Institutions Subcommittee Ranking Member Bruce Vento, and Capital Markets Subcommittee Chairman Richard Baker, he takes a somewhat different approach. And while there are some differences in starting points, what is clear upon examination of both bills, is that we agree on far, far more than we differ on. For example, we agree new affiliation authority for financial services providers; the nature of those products and services we consider financial in nature, the appropriate regulatory framework, the importance of functional regulations, to name just a few.

As we proceed and even before markup, I think the best approach for us is to obtain as broad a bipartisan support as we can to maintain consensus where we clearly have it, to avoid contentious issues that are not central to the changes we must make and achieve compromises that I believe are readily obtainable on those few but vital issues where we differ.

If we are to get beyond committee and have a bill that actually can be enacted into law, there is one central player in this discussion that we cannot ignore, and that is the Administration. And so most importantly the bill we will introduce this afternoon will include language on the controversial operating subsidy issue that the Treasury can enthusiastically support.

Now, that is very important, because without Administration support, we risk legislating in vain. And without that support, it will prove extremely difficult to obtain the broad bipartisan support that is essential if we are to succeed. There are a few issues that are going to be difficult, Mr. Chairman, and one deals with the thrift charter. Our bill is going to be silent on that.

I think modernization should be about moving forward, not taking existing authority from institutions when there is no real legitimate case, in my judgment, that there is a problem that they pose safety and soundness risks.

Second, and I know this is even more important to you as you have strong views about banking and commerce, others do, too, the Fed, Treasury, but I believe we all understand that there are existing financial-commercial relationships that must be accommodated if all of the industry is affected by this bill and to have the full range of opportunities it creates, and there is more than one way to accomplish this.

What Mr. Vento and I and Mr. Baker have done is to include within the bill the approach that was adopted by this committee in the last Congress as a starting point. There was ambivalence on the House floor. I mean, Mrs. Roukema offered an amendment for a 10 percent basket that passed; Mr. Leach offered an amendment for no basket that passed.

This area cries out for compromise. And I look forward to working with you as soon as these hearings are over to achieve that compromise on those issues where we differ, although, again, I reiterate, we agree on the vast, vast majority of issues, and I thank the Chair very much.

Chairman LEACH. Well, thank you very much, Mr. LaFalce.

Mrs. Roukema.

Mrs. ROUKEMA. Thank you, Mr. Chairman. I will try to be brief, I always say that, but let's see if we can be. I am pleased to be here today. I would also say that I had hoped, given the long history of this legislation going back many years and certainly with the intense work that we did last year, and as close as we came, that this would not be necessary. I might also observe that the Senate did some very excellent work last year through its committee, although it never got to a vote on the Senate floor.

I guess I am looking forward eagerly to these hearings, but I hope that we are not going to totally reinvent the wheel. I think there is some outstanding questions. We will ask those questions of the witnesses that are going to be appearing here. I hope we can restrict ourselves to new substantial information rather than going through a lot of the same rhetoric, but we shall see.

Mr. LaFalce has—and I am not intimating that there aren't still significant areas of controversy or differences of opinion—but I will say no one would have thought a year ago, or certainly not two years ago, that we could have come so close to enacting a bill and reaching apparent industry agreement relating to securities as well as the insurance questions. We have gone far beyond expectations. At least that is my understanding.

I will admit that some differences remain. These differences may be highlighted in comparing our bill, Mr. Leach, to Mr. LaFalce's bill. With respect to H.R. 10, I was happy to cosponsor, not that it had everything that I would like, but it is a more than just a good start, it is an excellent start.

But Mr. LaFalce's bill, which he is introducing today, does raise, as he also pointed out, the question of banking and commerce. But I would associate myself with at least the observation that this does cry out for compromise, and I think the compromise is out there. Whether it is definitional or some other approach, we can come to agreement as to how we face the real world, the real world of what is out there with respect to commercial interests as part of banking.

And I won't go into any more on that. We can give lots of examples such as the Deutsche Bank and Bankers Trust acquisitions and other issues, but we will leave it at that and hopefully we can come to some compromise on what these complementary activities could be, whether to define as a basket or otherwise.

But one of the other questions that continues, and I have been fairly, fairly clear, if not outspoken on this question, and that is the functional regulation and bank holding company versus the operating subsidiary. I will be eager to question the Administration witnesses on this subject. It is a continuing deep concern of mine that I would oppose the operating subidiary proposal as has been backed by the Administration. I would stay with the holding company format because I think that is a far better route to safety and soundness and the firewalls that we have always said so desperately are needed.

But I guess finally I would just conclude by saying, no matter what, we have got to pass a good bill this year. It will be a sad day if this Congress, both the House and the Senate, say that we are not able to fulfill our constitutional responsibility. If we don't get this done this year, the genie is already out of the bottle, we will never be able to put the genie back in the bottle and we will have essentially said that the regulators and the courts will be the jury on this subject and will be writing financial modernization rather than the Congress.

And I for one do not intend to abdicate our constitutional responsibility here in that respect. Let's get to work on it and get it done.

Thank you, Mr. Chairman. I appreciate it.

Chairman LEACH. Thank you, Mrs. Roukema.

Mr. Vento.

Mr. VENTO. Thanks, Mr. Chairman. I appreciate your holding these hearings on H.R. 10, financial modernization in general, and especially want to welcome all of the witnesses. Most of them we have come to know by their first name, Mr. Chairman. We especially want to welcome R. Scott Jones, the new president of the American Bankers Association from Red Wing, Minnesota. It is a little bit out of my area, but I claim him as a Minnesotan, and I think he is going to be a very positive force in terms of working with us.

He has been well schooled in our State, running a financial institution from Red Wing, Minnesota, and we look forward to his testimony. I think if we look at his testimony today and follow his instructions, we would be well advised it comes close to embracing many of the best ideas of both bills.

Mr. Chairman, last session, in spite of our admonitions, we missed enacting a law on modernization by a wide margin and, in fact, some significant polarization exists today, because of the outcome and especially the process. Things put over the fire too long burn. A wonderful margin in the House with voting strung out for an hour and a Senate measure that was to be enacted upon without formal House input and facing a veto threat, there is not much to be emulated in that process model. We can and should do better.

So today is February and like the swallows returning to Capistrano, financial modernization returns to the Congress, congressional agenda, home to roost once more. Hopefully we can end

this seasonal financial modernization phenomena in this Congress and move on down the trail or down the flight path toward modernization of financial service laws, so that we can properly reflect the current market situation.

Encouraged by the regulators competition, the law code and policy, we should be able to provide positive framework for financial services in the future on which to build our mixed economy.

Today there is much—today may be a crash course for some of our new Members and intensive refresher for the rest of us. These three days of hearings scheduled so closely together will make it hard to digest all the testimony and issues. It is important to provide this forum and continue to explore the topic fully in the committee before moving to write and act upon financial modernization.

Certainly we appreciate the continued work and partnership of our many scheduled witnesses. I applaud the work of Chairman Leach and Ranking Member LaFalce for advancing measures which build upon the work of our past four years. These measures contain sound provisions that will help shape the final proposal this committee can pass in a bipartisan basis.

With the active interest and support of House Members, outside parties and the Administration we can work to accomplish this goal. The task will be to keep existing support on board while adding others without tipping the boat. We need to build bridges across party lines to obtain a sense of committee ownership for the policy path as we move to the Senate so that we can ultimately produce a measure that will win the approval of the Administration and a Presidential signature.

We have much to work to do, but every journey begins with a single step or should I say a series of opening statements. We will encounter issues upon which we agree or disagree, commercial basket, WFIs, unitaries, affiliates, pushouts, op sub banking semantics, you name it, we will debate it, process it and vote on it.

In the end this committee and the Congress can produce a bipartisan bill. And if there is a willingness and a little luck, I guess, to work together. Thanks, Mr. Chairman, I look forward to working with you.

Chairman LEACH. Thank you, Mr. Vento.

Mr. Baker.

Mr. BAKER. Thank you, Mr. Chairman. I want to again applaud you for your tireless efforts on this subject matter. You more than anyone have fought a very long uphill battle and continue to remain tirelessly optimistic. And for that, I want to express my appreciation. I also would like to respond to the observations of the gentleman from Minnesota with regard to the swallows returning to Capistrano. When they all too often have flown into the room, we have opened hunting season. I think it appropriate that we at least have one live bird leave the committee room, for our future's interests.

It is important, Mr. Chairman, you succeed. Over the years technology and markets have changed rather dramatically, and those who are bright in the market have leveraged congressionally created loopholes to have allowed innovations to proceed, despite the fact that laws written in the 1930's or attempting to regulate mod-

ern business practice. And it really raises the question, why should Congress arbitrarily block innovation?

I have always felt the core of the free enterprise system is to allow individuals or businesses to make business judgments they deem best for themselves or their investors. And it seems a bit ironic in a day and time when literally billions of dollars are being traded this morning in electronic commerce or billions of dollars are changing hands in business products that simply did not exist a decade ago, that we expect the laws written in the 1930's to possibly keep pace with the market.

Mr. Chairman, whatever the end product may look like, I want you to know I, for one, will certainly support that effort. However, I think during the course of these deliberations, valid differences of opinion on policy and financial regulation will be offered. I hope the committee product at the end of the day is one which can navigate through the congressional process. I join with others in saying that we are once again far too late in developing a common sense framework in which technology innovation and business practice can proceed in a logical manner.

Thank you, Mr. Chairman.

Chairman LEACH. Thank you very much, Mr. Baker.

Mr. Kanjorski for a statement.

Mr. KANJORSKI. Thank you, Mr. Chairman. Abraham Lincoln took three minutes to make the Gettysburg Address. I will try to be as succinct. I want to compliment you for holding this hearing. I am looking forward to seeing how we can craft a bill that meets at least three concerns of mine. I start off with the proposition that in some meetings I had with the Treasury Department, there was a strong indication that just the need to pass legislation is not the call of the day or the right order. We should only pass legislation if, in fact, it is good and improving legislation, and I think that should be our guideline here.

The considerations and concerns I have for this bill are: one, I still do not know what should happen in separating commerce and banking. Maybe we should wait and see what happens in Japan and Germany, and analyze whether any of their significant economic and financial problems have been caused or could be protected against if we keep the separation. So, I am certainly interested and also worried about rushing headlong into breaking down the firewalls of banking and commerce.

Second, there is not any question that in any legislation that comes out that consumers' protections and rights should be adequate and even superior to what they are now. One of the major concerns that we all have, of course, is the protection of privacy, upon which the modern world and electronic revolutions have caused concerns.

My final concern is that every community should share in the rewards if we modernize financial services. It is just not the big banks, but it must be the small banks. It must be the small towns, and it must be those areas of the country that could be under extraordinary pressure if we pass modernization. It is a free, open field for the reorganization of assets and financial control of the country as opposed to facilitating the development of banks.

I particularly look forward, Mr. Chairman, to testimony today by E. Lee Beard of my congressional district, who is chair of America's Community Bankers. I think her testimony will give us a great deal of insight as to how pending legislation will not only modernize, but also provide the outline and the playing field for small community bankers and the distressed communities of Americans that rely on the community bank system.

I look forward to joining with my colleagues on the committee in the debate today, but I am at this point not able to support any particular piece of legislation until these three concerns are addressed. Thank you, Mr. Chairman.

[The prepared statement of Hon. Paul E. Kanjorski can be found on page 257 in the appendix.]

Chairman LEACH. Well, thank you very much.

And let me welcome our panel. We have before us very distinguished American citizens representing some of the finest American public corporations in finance.

Our first witness will be Mr. David H. Komansky, who is Chairman and CEO of Merrill Lynch & Company. He will be followed by Mr. Michael Patterson, who is Vice Chairman of J.P. Morgan & Company and Chairman of the Financial Services Council; Mr. John B. McCoy; who is President and CEO of BANK ONE Corporation; and Mr. Richard L. Huber, who is Chairman, President and CEO of Aetna, Inc.

We will begin, unless there has been mutual accommodation with the panel, with Mr. Komansky. Please proceed.

STATEMENT OF DAVID H. KOMANSKY, CHAIRMAN AND CEO, MERRILL LYNCH & CO., INC.

Mr. KOMANSKY. Thank you, Mr. Chairman, Members of the Banking Committee. I am honored to be here at Capistrano or, excuse me, I am honored to be here with my colleagues from the banking and insurance industries, and I thank you for the opportunity to testify. The American financial services industry as you know is second to none. We have achieved leadership in every major area of global finance, but today this international leadership is threatened because of an archaic regulatory system here at home.

In our global economy capital is dispatched around the world at the speed of light, but the laws that govern our markets were written at a time when high technology meant talking pictures. Mr. Chairman, we are speeding into the 21st Century in a vehicle that was designed in 1933. This is the legacy of the Glass-Steagall Act which, as we all know, divided America's financial services industry into neat boxes, determined by products. Banks, insurance companies and securities firms were left to operate in their own worlds with very little competition among them.

For consumers, this meant separate trips to a broker to buy stocks, to a bank to make deposits and so on. But the realities of the marketplace have not squared very well with this narrow view of financial services. Today our clients, your constituents, increasingly find that their most precious commodity is time. They demand convenient, one-stop shopping to meet their financial needs

from checking and savings accounts to mortgages and estate planning.

But thanks to our outdated laws, financial firms have only been able to meet these needs by becoming corporate contortionists. We are forced to exploit loopholes or look to regulators or the courts for latitude to enter into another industry's turf. This is not only inconvenient and costly to consumers; it has given our foreign competitors an unfair advantage.

No other industrialized country still regulates its financial system this way. Europe has long allowed its financial houses to offer banking, securities and insurance services. And even Japan reformed its version of Glass-Steagall last year. We are now the only developed country in the world that has not lifted the barriers that segregate financial services. And this is more ironic, because the United States through the World Trade Organization, the IMF, the Treasury and the Commerce Department advocates free and open markets and financial reform throughout the world, but we are not applying that same principle with the same urgency here at home.

In the absence of comprehensive reform, we have had piecemeal changes such as the easing of restrictions on commercial banks which has allowed them to offer some securities services. But because no similar opportunity exists on the securities side of the equation, a one-way street has been created in which banks can purchase securities firms, but securities firms cannot buy commercial banks.

For example, Chase or any large bank around the world can buy Merrill Lynch. But Merrill Lynch cannot acquire a large bank either here or abroad. So our regulatory system is not only out of date, it is out of balance. One result is that over the past two years, 40 U.S. securities firms have been purchased by American or foreign banks, and this one-way consolidation is accelerating.

Eighteen months ago, Bankers Trust purchased Alex Brown, our Nation's oldest securities firm. And then last fall, Bankers Trust was acquired by Deutsche Bank, creating the world's largest financial services institution. The recent introduction of a unified European currency has triggered more consolidation. Our colleagues across the Atlantic are creating larger, more highly capitalized companies that are better equipped to compete, and this is certain to have implications for American firms.

We are at a historic juncture. Congress has a unique opportunity to act to preserve American financial leadership, and I am confident that you will act because of the constituency for modernization. It includes every American who owns a mutual fund, who has purchased an annuity, who wants a checking account with a good interest rate, or who holds an insurance policy. In fact, the Treasury has estimated that reform would save American families more than $15 billion a year.

The consensus for action is now so strong that all the remaining issues appear resolvable. If fiercely competitive financial firms can set aside their parochial interests and achieve consensus, surely our Government agencies can do the same.

For the sake of the Nation, all of us need to focus less on turf and more on common ground. Mr. Chairman, the situation is serious and straightforward. If we do not reform our financial service

laws, there will be a price to pay in American economic leadership. The world's financial system is now being reordered for the next 25 years. Our choice is simply to lead, follow, or get out of the way, and I think we should lead. Thank you very much.

[The prepared statement of David H. Komansky can be found on page 262 in the appendix.]

Chairman LEACH. Thank you, Mr. Komansky.

Mr. Patterson.

STATEMENT OF MICHAEL E. PATTERSON, VICE CHAIRMAN, J.P. MORGAN & CO. AND CHAIRMAN, FINANCIAL SERVICES COUNCIL

Mr. PATTERSON. Thank you, Mr. Chairman. I, too, am pleased to have the opportunity to testify before this committee today on behalf of the Financial Services Council. The council differs from other organizations that will come before you, because it represents the views of companies active in all sectors of the financial services industry. Our membership includes banks, securities firms, insurance companies, and diversified firms that engage in both financial and nonfinancial activities. We compete head to head, but we share the conviction that fundamental reform of America's financial laws is essential.

Mr. Chairman, unlike the case in prior testimony before this committee, I do not think it is necessary to dwell on the basic arguments for reform of Glass-Steagall and Bank Holding Company Acts. The intellectual and practical cases for ending the artificial segregation of financial services activities are now virtually unchallenged, whether by market participants or policymakers. The question now truly is how, not whether, to achieve this final reform.

In that vein, I would like briefly to reinforce three points made in my written testimony: First, the degree to which with accelerating speed the market is demonstrating the need for legal reform; second, the importance of building into any legislation sufficient flexibility to anticipate the inevitable continuing rapid changes in technology and financial services; and third, the importance of seizing the current opportunity of industry consensus and legislative momentum without becoming derailed by disputes about exactly how and by whom diversified financial services providers will be supervised.

The first point to emphasize is the rapidity of the convergence and consolidation of financial services both in the U.S. and abroad. As a result of developments we are all familiar with, involving information technology, institutional savings, product innovation and customer preferences, banking, securities and insurance products are increasingly similar and competitive with each other, and it is inefficient and very costly to providers and customers alike to separate their provenance. Even within the constraints of current U.S. law, the market has reacted dramatically.

Mr. Chairman, just since the beginning of 1995, when you took the chair of this committee and declared financial services modernization to be your top priority, over 20 banks have started so-called Section 20 securities affiliates, scores of banks have expanded their mutual fund and insurance activities, securities firms have become important competitors in the syndicated loan market

and many firms have sought thrift charters to provide banking products.

In addition to these individual firm efforts, the convergence story is dramatically illustrated in the merger and acquisition activity across traditional industry lines. Taking into account only transactions with values exceeding $1 billion each, since the beginning of 1995 there have been $224 billion worth of M&A transactions globally across banking, broker-dealer, asset manager and insurance lines. These diversifying transactions constitute about a quarter of the value of all M&A transactions within these industries.

Incidentally, during the same period, there has been a total of over 280 acquisitions of U.S. financial services companies by foreign acquirers with a total value of $56 billion. The point is simply that the gap between U.S. law and market reality and sound policy is growing wider every day.

To come to my second point, the progress that financial services providers have made in adapting to market forces has been facilitated by regulatory initiatives but at a painfully slow pace, retarded by lengthy litigation and encumbered by burdensome restrictions and limitations. The loss of benefits of competition and convenience to consumers as well as the loss of economic value to U.S. financial services companies has been enormous.

There is no reason to believe that the pace of change will be any slower in the future than it has been in the recent past, or to believe that we can predict just what that change will be. Any legislative reform, therefore, should put a high premium on flexibility for financial services providers to respond promptly to changing customer needs. Legislation that impedes this adaptability because of insufficiently broad definitions of permitted activities or cumbersome approval processes or disputes about regulatory jurisdiction will weaken our financial system.

Finally, now is the time to act. For many years, those of us who sought reform were told by legislators that we industry participants needed to get our act together first. We have largely done that. H.R. 10 reflects an unprecedented consensus among previously warring industry segments; one that was laboriously achieved and cannot necessarily be counted on indefinitely. It is particularly frustrating to see such remarkable progress by the industry thwarted by disputes over issues of regulatory oversight.

I don't mean to trivialize those issues, they are important and some are difficult, but we ought not to keep our best teams off the field, because we can't agree on the referees. Market forces have largely broken down the economic barriers and differentiation among historical industry segments. It would be worse than ironic for obsolete legislative barriers to be preserved for lack of agreement about how to adapt the regulatory structure to the reality.

Thank you, Chairman Leach, for your perseverance and leadership in this effort and again for the opportunity to testify today.

[The prepared statement of Michael E. Patterson can be found on page 282 in the appendix.]

Chairman LEACH. Thank you, Mr. Patterson.

Mr. McCoy.

STATEMENT OF JOHN B. McCOY, PRESIDENT AND CEO, BANK ONE CORPORATION

Mr. McCoy. Good morning, Chairman Leach and Congressman LaFalce, Members of the committee. I am John McCoy, President and CEO of BANK ONE Corporation. We at BANK ONE are extraordinarily pleased that the House Banking Committee is taking up H.R. 10 so early in the 106th Congress. We pledge our continued support for financial services reforms. We believe this legislation accomplishes many critical and necessary objectives for this country's financial services industry relative to the international markets. H.R. 10 also levels the competitive playing field for insurance companies, security firms, banks inside our national borders.

Since this committee last took up H.R. 10, tremendous changes have occurred in the marketplace. CitiGroup was created, Deutsche Bank has agreed to acquire Bankers Trust, a slew of new thrifts and bank charters have been granted by the OTS and OCC, and BANK ONE has doubled in size. The accelerated pace at which the financial services industry here and abroad is consolidating is mind numbing.

This strong rush of affiliation among financial services companies demonstrates this Congress' immediate need to act. If not, the Congress and many U.S. institutions are going to be left behind. We know that the marketplace waits for no one and we applaud your understanding and appreciation of the big picture at stake here.

As most Members know, BANK ONE played an active role in the negotiations which greeted the Chairman's markup vehicle that you have before you. During the last Congress we worked closely with this committee, the House Commerce Committee and the Senate Banking Committee to assist in working through the many compromises required among the competing interests in the financial services industry to make H.R. 10 a reality.

We believe that the product you have before you enjoys the support of most banks, insurance companies and agents and securities firms. Some of this support has been provided reluctantly as negotiations among these traditionally warring industries were not easy. Nevertheless, as you will learn over these next three days, H.R. 10 has broad based U.S. business support, including the three industries most directly impacted.

At least four issues, however, remain very contentious. I want to take this opportunity to review them with you and give you some insights as to BANK ONE's position regarding each issue.

First, bank operating subsidiary powers. BANK ONE finds both the complementary and competing natures of the relationship between the two primary regulators, the Federal Reserve Board and the OCC, to be healthy and beneficial to bank holding companies in the national bank charter. We believe that this check and balance relationship provides the flexibility required to successfully move U.S. financial services firms into the next millennium. The bill you have before you restricts bank operating subsidiaries to engaging only in; one, any activity permitted for national banks themselves; or, two, any agency activity authorized for a financial services holding company. The Chairman of the Federal Reserve

and the Secretary of the Treasury have and undoubtedly will continue to debate whether or not these restrictions are appropriate.

BANK ONE's position is that national banks can and will effectively accommodate whatever resolution to this debate prevails. However, we do not believe that this issue is of a magnitude that should stop H.R. 10 from moving forward. BANK ONE strongly believes that before the operating subsidiary issue is permitted to derail or destroy H.R. 10, this Congress should respectfully adopt a King Solomon's judgment and offer to split the baby and lay the issue to rest.

Second, regarding the Community Reinvestment Act. As the 105th Congress was brought to a close, H.R. 10 failed to reach the Senate floor, primarily, we believe, because of differences of opinion as to the bill's impact on CRA. Frankly we believe that were this committee to take the pulse of the 535 Members of Congress regarding CRA, you would probably encounter 535 different opinions as to how it should be reformed.

BANK ONE is, we believe, working effectively and successfully with CRA. CRA's bottom line objective is BANK ONE's bottom line objective: use bank products and services to strengthen communities and families across all of this country's diverse demographic groups.

How banks' bona fide business objectives and Community Reinvestment Act and related regulations intersect is the topic of much debate. So much debate involving so many policies, procedures and interested parties, that we do not believe the issues can be adequately addressed in anything other than a stand-alone bill.

BANK ONE does not oppose CRA, nor do we have any blockbuster ideas as to how it could be made more compatible with the will of Congress. We are, however, ready and willing to work with you to reform what began as a very short and simple bill passed in 1977 and now has become a myriad of competing concepts and regulations both inside and outside this Congress. We think, however, that this debate should take place separately from H.R. 10.

Third, the mixing of banking and commerce. Under current law, insurance companies, security firms, mutual fund companies and some thrifts may affiliate with commercial firms. Only banks must remain separate from commercial endeavors. BANK ONE realizes that many Members of Congress, including most importantly this committee's esteemed Chairman, are fearful that the mixing of banking and commerce would result in an unacceptable concentration of power on Main Street and Wall Street.

However, BANK ONE does not interpret the economic history of this country, and the experience of foreign firms currently engaged in both banking and commerce, in the same way. We believe that, regardless of lines heretofore drawn by Congress, the distinctions between financial services and commerce grow fuzzier every day, particularly in the area of electronic commerce.

We are confident that the proposals that Congress has considered to mix banking and commerce could be safely and soundly executed by this Nation's financial services companies and commercial firms. We are equally confident that such affiliations can be safely and soundly regulated by the Nation's regulators without risking the

creation of oppressive concentrations of power that some Members of Congress feel.

We understand that informed, honorable people and institutions are of different minds on this issue. We also understand the changes usually come in inches not yards. We respectfully request that H.R. 10 include an opportunity for this Congress and the banking system to gain some actual experience and empirical evidence with the mixing of banking and commerce. We believe that this experience will not be as positive as some project nor as negative as some fear.

Fourth, regarding consumer privacy. Comprehensive consumer privacy provisions are not and should not be included in H.R. 10. Very few people understand the depth and breadth of the issues inherent in this topic or the potential consequences of any Government action for consumers, banks and the entire national and international economy.

Let me also add that, unlike other industry, banks and other financial institutions are already subject to extensive privacy regulation. In the last 30 years, Congress has mandated our compliance with a web of privacy laws that create real protection for customers, including the following:

We are required by the Fair Credit Reporting Act, which Congress recently overhauled, to abide by strict rules governing the sharing of information obtained from customers in the credit-granting process.

We are required by the Electronic Fund Transfers Act to disclose to customers our policies for sharing information about their accounts with third parties.

We are required by the Federal Trade Commission Act to abide by the terms of privacy policies we adopt for customers, and BANK ONE, like most banks, has in place a privacy policy. Having said all of this, I confess to you although I actively seek more and better information every day, I remain overwhelmed by all that I don't appreciate about what might constitute appropriate and desirable consumer privacy policies.

Part of the problem is that consumer privacy is an intensely personal matter and one that may be changing as technology evolves. One thing that cannot change is the foundation of trust upon which the financial services industry is built. Were we to lose that trust, BANK ONE could not exist. For this reason, we recently appointed a senior vice president to focus only on the privacy needs and expectations of our customers.

This office will also compare our practices against those of other financial firms, as well as other service providers, such as telecommunications and retail firms. And in focusing on the consumer privacy issue, it is important to remember that the effective use of consumer data is not unique to financial services companies. It is an essential element of the business of successful companies throughout our economy that are seeking better products and services for their customers.

BANK ONE believes we can learn from the many proposals being deliberated by various congressional committees, business committees and alliances, consumer groups and the international economic community. We don't have the answers yet. And like the

Administration, we are fearful that restrictive governmental action will cripple the emergence and growth of new technologies, Internet commerce and new consumer products and services.

Given the embryonic stage of these privacy issues, we implore the Congress to move at a slow and deliberate pace seeking the full understanding of the implications of any action before it is taken.

BANK ONE does not believe that issues such as consumer privacy, which have such enormous consequences on national and international trade and commerce, as well as for tens of millions of consumers throughout our Nation, can be dealt with adequately as a sidebar to financial services restructuring.

Again, thank you, Mr. Chairman and the Members of the committee for moving so persistently and aggressively for financial services reform. BANK ONE is committed to working with you and passing H.R. 10 this year.

[The prepared statement of John B. McCoy can be found on page 297 in the appendix.]

Chairman LEACH. Well, thank you, Mr. McCoy.

Mr. Huber.

STATEMENT OF RICHARD L. HUBER, CHAIRMAN, PRESIDENT, AND CEO, AETNA INC.

Mr. HUBER. Thank you, Mr. Chairman, and Members of the committee. I am Richard Huber, and I am Chairman and CEO of Aetna, Inc. And I am very pleased and honored to be able to testify before this committee and share with you my perspective on financial services modernization based on, first, my experience in international banking for some 29 years and, more recently, my experience in the insurance field.

I am confident that all of us on this panel agree that the legal and regulatory structures under which we compete, and let me tell you, we compete aggressively, are outdated and fraught with exceptions. I am just as confident that we would all agree that marketplace pressures and varying interpretations of law by regulators and the courts have intensified competition. I think we all agree as well that the consolidation of firms and expansion of product offering both domestically and abroad will continue to take place.

The reality is financial services modernization may occur de facto. Action is critical; the rapid evolution of banking, securities and insurance will not cease. And I have said modernization will happen with or without legislation. Restructuring the global financial industry will continue and, unfortunately, if Congress cannot pass meaningful reform, American institutions will remain handicapped by antiquated laws.

I have personally been involved in advocating financial services modernization for almost 20 years, and I have to admit that there have been many times when I doubted that Congress would find the courage to act within my lifetime.

Last Congress, you achieved what many observers thought to be impossible. For more than a decade, we and others in the industry argued that consumers and markets would benefit by unshackling the financial services industry from its 60-year-old legal structure. But as you well know, to be completely honest, the internecine warfare within the financial services sector was just as vociferous.

This committee and the 105th Congress successful negotiated a ceasefire within the financial services sector. You developed a legislative package that allowed each industry to put aside parochial differences and find common ground. The common ground can't be lost as you move forward. H.R. 10 achieved a tricky balance in reforming the regulatory framework by enhancing our competitive position abroad, while at the same time advancing domestic competition.

The insurance industry supported H.R. 10, because it embodied our main goal, making certain that banks entering insurance business be subjected to the same statutes and regulations that insurers not affiliated with banks must observe.

The insurance sector wants to slow the practice of Federal banking regulators granting insurance authority to banks without any of the solvency and other regulatory requirements of the State. Our goal is to level the playing field, not to seek any special exemptions or competitive advantage. Equal and functional regulation is the best guarantor of competitive equality.

One of Aetna's subsidiaries, Aetna International, operates in 17 countries throughout Asia, Latin and South America and Central Europe, selling pension, health, and life insurance products. When we enter an emerging market, we typically joint venture with one of the leading domestic companies in that country, frequently with a large retail oriented bank.

We often find that our foreign partners are mystified by the rationale, or some have said the lack of rationale, of our financial services regulatory scheme.

Let me share one of our foreign experiences with you, because we have seen some completely unexpected and positive outcomes which simply would not have been possible in our current regulatory model in the U.S.

Mexico is one of our most successful markets, where we now have 16 percent of the privatized social security markets and actually 25 percent on a wage weighted basis, 28 percent of the single premium annuity market and 29 percent of the individual life market.

We partnered with Bancomer, Mexico's largest retail bank, to provide the distribution mechanism for our product. Initially, we used the traditional agency distribution network. Then in 1997 as Mexico privatized its social security system, we decided to use the bank's 1,000-plus branch network to reach the largest possible share of the market.

Seeing the tremendous success of this model, we set up a separately chartered insurance company with the same back office as our existing company to sell inexpensive, plain vanilla auto, homeowners and life insurance through the same branch network. We expected to draw some of our agency-distributed business, but we felt it was a worthwhile experiment.

The results were very interesting. The bank sales strategy reached an entirely new market segment, lower- and lower/middle-class Mexicans who were never reached by the traditional, higher cost distribution system. Now tens of thousands of Mexicans are participating in the insurance market, protecting their families

from devastating catastrophic expenses, generating savings and creating security options.

And in little over a year our new subsidiary became the sixth largest insurance company in Mexico with very little cannibalization of our existing agency distributed business. The phenomenon did not occur because of significant increases in discretionary income; it happened because of a different way to approach people about insurance. Ready access and long-standing trust of the bank are the explanations.

The social impact of this is significant as there is significant potential of a strengthened lower/middle-class in Mexico. The outcome would not be possible in the regulatory structure similar to ours. Increased economic security is part of the outcome in Mexico, and more funds channeled into productive sectors of the economy. Perhaps it could be one of the consequences of financial services modernization in this country. I will leave the discussion of lessons learned in our numerous experiments with privatizing social security for another debate.

In closing, Mr. Chairman, I want to once again commend you for holding this hearing and for starting this process so quickly in the new Congress. I offer you my support and assistance moving H.R. 10 forward, and I wish you and your colleagues on the committee the necessary diplomacy, energy and commitment to maintain the delicate balance required to pass H.R. 10 in the 106th Congress, within my lifetime.

Thank you.

[The prepared statement of Richard L. Huber can be found on page 304 in the appendix.]

Chairman LEACH. Well, thank you. And we hope you have a long life.

I just have one question. But before raising it, I want to make a clarification, and it relates to Mr. McCoy's extraordinarily thoughtful presentation. But there is an element of straw man that I want to put down, John, and that is the bill before us authorizes bank holding companies the right to engage in activities, financial in nature, which is a broader definition than currently applies of incidental to financial.

The legislative history that we very carefully developed in the last Congress was to underscore that this applied to electronic issues and so the basket is unneeded to protect activities that move into the electronics nature. There has been a lot of discourse in recent weeks with the example given of American Express and their ownership of some travel magazines, that American Express being the financial company but disproportionately more travel oriented than some other companies.

In my view, that would fall under the rubric of incidental to finance. But I am very open to the new discussion about adding to the authority of the Federal Reserve Board of approving activities complementary to financial services. And I think that covers it very extraordinarily.

But let me come back to the basket and to make this distinction in the American Express example. If BANK ONE wanted to buy the *Cleveland Plain Dealer*, I would consider that outside of incidental to banking and complementary to banking. But it would be

allowed under baskets. And that is a distinction that, in my view, would be very inappropriate for a financial institution to enter into. And it is a limit placed on the financial institution. One might argue banks do put advertisements in newspapers, as do many other aspects of commerce.

But it is an example of where I think baskets could lead to what I believe would be inappropriate, whereas flexible language involving "incidental to" or "complementary to" would be of a more common sense direction. And I just throw that out. And frankly, we may have a difference of judgment on that, and I recognize that, but that is the view that I would hold on that particular issue.

But the question I want to ask is simply one that relates to the position of the United States in the international marketplace. Mr. Komansky, do you believe that the Merrill Lynch Company is better positioned to compete internationally with or without legislation before us?

Mr. KOMANSKY. I think clearly our position would be enhanced with the legislation that is before us.

Chairman LEACH. Mr. Patterson, would that apply to your company?

Mr. PATTERSON. It would certainly apply to J.P. Morgan, and I believe that most of the members of the Financial Services Council, if not all, would agree as well.

Chairman LEACH. Mr. McCoy.

Mr. MCCOY. Yes.

Chairman LEACH. Mr. Huber.

Mr. HUBER. It would have relatively little impact. We are able to compete pretty well internationally, and quite frankly, it would have relatively little impact on us.

Chairman LEACH. Fair enough.

Mr. LaFalce.

Mr. LAFALCE. A bit of a history. I have been working for financial services modernization since I have been in Congress. I worked closely with Mr. Patterson for virtually all of those years and certainly with his predecessors at J.P. Morgan; did not always work closely with the securities industry, because up until the late 1980's, they were not always on board.

And so I welcomed their conversion and in joining the effort, and the same thing is true with respect to the insurance industry. And we really didn't have until recently an association with BANK ONE, in particular, but banking community, it depended on which group you were with. At one time they were opposed to repeal of McFadden Douglas, and we had to bring them along, but we did. NationsBank opposed the repealing of McFadden Douglas until they were big enough to favor it, I think. So beauty is in the eyes of the beholder, but I think we have been fairly constant to our vision.

The Chairman just mentioned something about baskets and newspapers and he points out a particularly difficult situation of course. I just want to point out that in a prior life when I was Chairman and Ranking Member of the Small Business Committee, I saw to it that because of the peculiar situation with newspapers in the media, that no SBA loan could be given to the media. They just have a sui juris position within American society, and so I

don't want to take the worst possible example and use that as the model.

We go to you, Mr. McCoy, your testimony on page 4, "We understand that informed, honorable people and institutions are of different minds on this issue. We also understand that change usually comes in inches, not yards. We respectfully request that H.R. 10 include an opportunity for Congress and the banking system to gain some actual experience and empirical evidence with the mixing of banking and commerce. We believe that this experience will not be as positive as some project, nor as negative as some fear."

I think that is a very good statement. It is balanced, it is reasonable. Let me follow up with a question. What experience has your bank and the banking community, if it is not your bank, in particular, had with some fixture either internationally or domestically, for example, through an SBIC, number one. Number two, what did you mean by this moving ahead in inches? Do you have any suggestions? Is it a continuation of the unitary thrift charter or because you don't like unitary thrifts because you are a bank? Is it some modest mixture, you know, where you are talking about some percentage less than 15, or do you have something else in mind?

Two-part question, the first part is the existing historical experience, the second is the future experience that you would like to see.

Mr. McCoy. The experience that we have had dealing in commerce is very limited. Usually when we deal in commerce, it is because we made a bad loan and we end up taking over the company. So I am not sure that that is good experience. We have had experience in venture capital, which is an area, I think the area of commerce that I would——

Mr. LaFalce. What has your experience been in venture capital in an SBIC?

Mr. McCoy. We have had SBICs. Both BANK ONE and First Chicago have a history in venture capital investments.

Mr. LaFalce. That is something I have a lot of experience in too, dealing with the small business community, we have had bank SBICs separate affiliates for decades and decades and decades, and they have done great things with virtually no downsize.

Mr. McCoy. Exactly.

Mr. LaFalce. Go ahead.

Mr. McCoy. You have answered my question. I think the—and I would say that as much as I like the *Plain Dealer*, I have no interest in acquiring the *Plain Dealer*. The area on the commerce side that is most interesting to me is what is happening on the Internet. And the Internet is a total new game——

Mr. LaFalce. I want to say when I see some of the institutions that have bought media today, you would be a lot better than some of those that presently own them, OK.

Mr. McCoy. But I think on the Internet, this ability to be an aggregator, what is our relationship with Yahoo? Can we be a website where people are coming to us to get to other commercial sites? So that is a very important area to me. What are inches? We have grown in our position inch by inch. And so I don't know whether 5 percent is the right number, I don't know whether 10 percent is the right number. I certainly am not for 100 percent, I think it has to be limited. And we will learn. And I will tell you

that there will be mistakes made, but I think there will be real gains that will accrue from it.

Mr. LAFALCE. Thank you.

Chairman LEACH. Thank you.

Mr. McCollum.

Mr. MCCOLLUM. Thank you very much. I might comment on the newspaper analogy that Intel, Microsoft, Lockheed Martin, if they started buying newspapers, I suspect we would be just about as concerned or more than if banks did.

Mr. Komansky, you mentioned, speaking of consolidation, that I think that 40 security firms, U.S. security firms have been acquired by banks since we changed the law in 1997. Has this had any negative impacts, as far as you know or has it increased competitiveness? Has it been positive? Negative? How do you view that?

Mr. KOMANSKY. Well, I will clearly say it has had positive effects on some of the major banks that acquired securities firms, but negative effects on pure securities firms that have to compete with those much larger entities.

Mr. MCCOLLUM. What has it done for the consumer?

Mr. KOMANSKY. I think that is still yet to be proved. Personally I think in the end the question of competition will determine that. I have no problem with competition. In fact, that is what affords us the opportunity to do what we do. But I do think it is imperative that we have the opportunity to achieve the size and scale to be able to compete with much larger entities.

The combination of a major bank with a securities firm results in a multitalented entity with a huge financial capability. On the other hand, a typical or even the largest investment bank from a financial point of view, a balance sheet point of view, cannot achieve the same capability. So we do without question feel that we have been playing on a playing field that is tilted against us.

Mr. MCCOLLUM. But if H.R. 10 is passed that will level that playing field to a largest extent and the competition that has actually probably grown a little bit with the banks acquiring the security firms will continue to occur more broadly based actually?

Mr. KOMANSKY. Clearly if H.R. 10 or a modernization bill were passed, it would certainly then make it possible for firms such as Merrill Lynch or some of the other major investment banks to at least attempt to level the playing field and not be blocked by legislative barriers.

Mr. MCCOLLUM. Mr. Patterson, you mentioned that you believe that financial holding companies should be permitted to conduct de minimis nonfinancial activities. I am just curious what you think of when you think of the term de minimis?

Mr. PATTERSON. In my testimony, Congressman McCollum, what I was stressing was that the definitions of permitted activities be broad enough through the Fed's interpretive power under the rubric of incidental and complementary, as Chairman Leach has mentioned earlier, to include activities that might not by themselves be viewed as financial, but are incidental to and complementary to financial activities.

The Financial Services Council philosophically would support a mixing of commerce and banking, but for purposes of our comments on H.R. 10, it is the former point I was trying to make.

Mr. McCOLLUM. Well, I understand it. The only reason I ask you is de minimis has a lot of different connotations. We are dealing with that term quite a bit here. And I didn't mean to subject you to trying to give me a laundry list, but I realize it is a difficult concept to always define for our purposes.

Mr. McCoy, you also stated something interesting to me, you said with regard to operating subsidiaries, something to the effect of let it rest and do not destroy the entire bill. I am curious what your thought process is on that. My concern is that Treasury, as you know, is very much pressing for an operating subsidiary power that we might not be as so willing to give as a committee, but ultimately we will have a bill signed into law. So I am curious what you were thinking about when you said let it rest, how do we let it rest considering that sits there with the reality of legislative process?

Mr. McCOY. I think this contention between the Fed and the OCC is one of the more frustrating things to me as a banker. This is more of a regulatory issue that you would hope that since we do work for one Government, that you could work it out within the Government.

Mr. McCOLLUM. We feel that way, too.

Mr. McCOY. It is hard for me as an outsider to say how to do it. I think we need to reach out to both to find a way, because I think it can prevent the bill from occurring which is a negative. So I am willing to try to find that compromise. I don't think we found it last time. I hope with this bill that is going to come out this afternoon, there may be a way to get some compromise there. And I think——

Mr. McCOLLUM. I yield certainly to Mr. LaFalce.

Mr. LAFALCE. Treasury has come a long way. Basically the provisions with respect to operating subsidiaries is the one that was offered by Congressmen Vento, Bentsen and myself on the floor last year, that Treasury wouldn't support, because its authority for operating subsidiaries was not broad enough. We did not change; Treasury changed. And they have made major concessions in arriving at the point where they now can support that limited operating subsidiary authority.

Mr. McCOLLUM. As my time is up, but I yielded, I would like to make the one comment and that is, Mr. McCoy, and others, I think as opposed to the last Congress, when I sensed the issue of modernization wasn't ripe in the sense that we had such an uphill climb to go, I think in this Congress it is ripe, and I think we are closer and this is why.

But thank you, Mr. Chairman.

Chairman LEACH. Thank you, Mr. McCollum.

And let me just say to my colleagues we are going to try to stick fairly rigorously to the five-minute rule and one of our panelists definitively has to go at noon, and that is understood.

Mr. Vento.

Mr. VENTO. Almost all of these—well, I mean to the witnesses that addressed it, I will address the issue of, in this panel, as I un-

derstand it, the relationship between commerce and banking and that they are inextricably tied. I was interested, Mr. Chairman, in your example of the *Cleveland Plain Dealer* and was wondering if you know as a banker you made the loan, and then it was a default, and then you would become an owner of it. Besides which, of course, I can think of a lot of problems with the *Cleveland Plain Dealer* being owned by a large entity of any sort, in terms of what it might mean. There has been obviously a lot of concern about various personalities of the news media, as Mr. McCoy I think was referring to, or others.

But I just think that from what I am hearing here from this panel or what I read in the testimony of others, everyone seems to understand that, you know, we can't talk about commerce and banking, it is like talking about the king's new clothes; you know, it is there, but we have to pretend as though it is not there. And well, I might have had some reservations over the years that we move in this direction. I mean I look at this litany of examples of exceptions that we have and wonder why we aren't addressing this. It might make someone feel good, but I think the reality is if you choose not to embrace or deal with it, that we, in essence, are not doing as precise a job as we can legislatively and giving direction then to the regulators as to what the nature of the proportion of this and the relationship ought to be in the sort of stated denial here with the facts of the marketplace.

I mean does anyone on this panel think that we should require brokerage or insurance that have an equity investment not to be able to have a bank—a holding company affiliate?

Mr. Komansky.

Mr. KOMANSKY. No, I would like to try to adjust that. Our concerns about commerce are basically focused around our capital raising activities on behalf of clients, which could take the form of either venture capital investment or merchant banking forms. And, in fact, there are even certain techniques of raising equity in the public markets, where we would stand as an intermediatory and for a period of time could well technically have a large percentage of the equity holdings of that company in our ownership at our risk until we can transfer that risk into the public markets. So we would be concerned about those activities are treated.

In addition, the other set of activities we would be concerned about are investments that we make, particularly nowadays, in the information services area. We happen to have been the original investor in the Bloomberg News Service. The motivation behind doing that was that we needed the development of those systems for our training rooms, and that is how that started.

Today, in this day and age, with the activities of Silicon Valley, it is critical for us to be able to have alliances with small software companies, developmental companies out there, who, in essence, can help us develop proprietary software, proprietary applications. So our particular—and I think this goes for much of our industry—concern when it comes to commerce is not the example of owning the newspaper, but is more in line with those activities that Chairman Leach outlined as complementary to our business.

Mr. VENTO. I am not so clear if that language is going to get you to where you are at. I understand you don't want to divest of those

particular equity investments, they are a necessity, they are part of doing your business in terms of offerings and so forth, but banks would be restricted.

We saw this in the last bill by providing a 15-year grandfather for insurances and brokerages and no grandfather and no opportunity for banks, which is sort of interesting. I guess if you happened to open a securities firms, you are all right.

I had a question on the securities side. For 15 years one of the issues on the insurance side deals with this umbrella of regulator in terms of the Fed being the ultimate determiner when there is a bank affiliate insurer type of relationship. And under current law, State insurance regulators have authority to approve, disapprove a condition of a transaction under which control of an insurer would change.

H.R. 10 would modify that and give the Fed the control and basically pull out the State regulator. Now we don't have a national insurance regulator, much to the chagrin of some and to the applause of others. In any case, they would be entitled—State insurers would still be entitled to notice, but that would be beyond these, however. They would have to appeal to the Fed if they wanted to change a Fed decision. This basically set the Feds up as a de facto in the national regulator.

Mr. Huber, do you have any comments on that to help us? No guidance for them incidentally in the bill as to how to make this issue.

Mr. HUBER. I think that the ACLI and the insurance industry as a whole is debating within itself whether really we should continue to favor State regulation or support some form of Federal regulation. There are pluses and minuses on both sides, and this is still something that is being debated very actively. And believe me, going around as I am now to something like 31 States to get an approval for an acquisition, there are days when I wouldn't totally mind having some form of Federal regulation. But this is still something that is being discussed and I think it would be premature to comment on it.

I would like to make one final comment, though, on the commerce issue. We have one of the most relentless, ruthless regulators known to man. It is called the investor community. And the investor community has told us loud and clear that they want us to focus, focus, focus. They have led us to divest a number of businesses that were insurance businesses, but they were not related to our core business.

And to me, this is the biggest regulator that I have, the guys who buy and sell my stock, and they tell me in every way that they want us to focus on the very few businesses we are good at and get out of everything else.

Mr. VENTO. Thank you.

Chairman LEACH. Mrs. Roukema.

Mrs. ROUKEMA. Thank you, Mr. Chairman.

Some of my questions have been asked by Mr. McCollum or have referenced by Mr. LaFalce. While we seem to be making progress here, I don't think I have gotten quite the specificity that we might have. I do understand that we want to get a bill. But I am still concerned, I believe that the question between the Fed and the Treas-

ury in terms of operating subsidiaries is more substantive than I think has been thus far described by any of you. I don't quite know how we split that baby in half.

But I do think that there are substantive issues about going into this new world where a Fed—a holding company pattern provides more safety and soundness assurances than some of the other proposals. If anybody would like to speak with more specificity on that, I would really appreciate it. I think we are all making a practical, maybe a programmatic approach. But I am not sure that we have defined how we split that baby in half, and it ain't that easy I am afraid, because we have been toying with this for a long time.

But the other question is the question of the commercial basket, and I know now we are—that is a dirty word now, basket, we are talking about complementary activities and ways of compromising that. And I am all for that, if we can. However, I heard your answer to Mr. Leach, and my question is, I don't know that common sense necessarily will solve the problem as to how we get to a definition of those complementary activities without—because I see it—we laid a problem out there, is that it would become so convoluted and discretionary in terms of regulation that I am not quite sure.

Could anyone here be a little more specific about what you mean in that regard, commercial complementary activities? Anyone? Mr. Patterson, please.

Mr. PATTERSON. I am not sure that this is going to be as specific as you would like. But I have been thinking about Chairman Leach's tantalizing example of the *Cleveland Plain Dealer*. Clearly in today's world that would appear to everyone not to be a financial or even related to financial activity. And yet I think we all know that the way news is delivered to consumers in the future may easily be changed by developments in electronic technology.

Banks and other financial intermediaries deliver a lot of information to their clients and their consumers increasingly using electronic technology. Indeed, there are many who think that the real future of financial intermediaries is in providing advice and information rather than commoditized traditional financial services. Would a bank that provides a vast amount of financial information to its customers and decides to add general news to that delivery of information be engaged in an activity that was not complementary to its financial activity?

I think there is at least an issue there, one that will have to be dealt with in the future in the context of future technological developments. And I simply wanted to make the point earlier that through words like complementary, which cannot be defined with precision now, we introduce into the bill enough flexibility to deal with those changes in the future.

Mrs. ROUKEMA. Mr. McCoy or Mr. Komansky? And could any of you relate it to the future? After all, we are talking about global economic competition and we already have Deutsche Bank out there. Yes, Mr. Komansky.

Mr. KOMANSKY. One of the things I think that we have to try to keep in mind, as I said earlier, one of our concerns was the ability to retain the ability to make investments in Silicon Valley for research and development and for access to systems and technology.

If we had had this conversation three to five years ago, this would have been the furthest thing from our minds and something we certainly at that time would not been involved in nor had very much interest in being involved in.

But it goes I think to what Mr. Patterson said, the changes that we are experiencing in the marketplace, both because of the advent and the advances in technology, the issues that are brought about by globalization and that are then exacerbated by piecemeal deregulation around the world, almost preclude what you are searching for. I understand why you are looking for specificity.

But to be able to forecast the impact all the changes our industries will experience at this point in time is frankly almost impossible. That is why I too favor flexible language and hopefully some sort of guidance to the regulatory body of the intent of Congress. I think it is going to be very difficult to look to the future with a real degree of preciseness.

Mrs. ROUKEMA. Thank you. I don't know whether the Chairman would give Mr. McCoy a minute.

Mr. MCCOY. I would agree with David very much. I think that just what we have seen happening in the Internet in months changes what we may want to do. And so I think we are going to have to depend on the regulators to define that term, because ten years from now, what we will be doing I think will be very different. And I think to have that term not precisely defined, but trusting in the regulators, is a better way to go.

Mrs. ROUKEMA. Well, perhaps I have another question at another time. Thank you. That has been helpful. It has been helpful.

Chairman LEACH. Thank you.

Mr. Kanjorski, let me say, we do have a vote on. It is your choice. Do you want to return?

Mr. KANJORSKI. Yes.

Chairman LEACH. The hearing is in recess, subject to the vote.

[Recess.]

Chairman LEACH. The hearing will come to order.

Mr. Baker.

Mr. BAKER. Thank you, Mr. Chairman.

I have a series of questions. I know the panelists are well pressed for time, so hopefully your responses can be as succinct as possible.

Mr. Patterson, on page 11 of your testimony, you basically describe an interest in some non-financial activities that might be included in reform measures. You do go on to qualify, subsequent to page 11, that it might be necessary to regulatorily restrict those non-banking activities, but certainly we should look at those being some—in some scope permissible.

Under the Bank Holding Company Act, Section 4(c) in the series that follows current law provides for equity investment in a domestic corporation up to 24.9 percent of domestic company ownership, non-voting. I find, and always have found, it to be highly ironic that the same provisions allow a bank holding company to own up to 40 percent of a foreign corporation.

Why is it inherently more safe for the U.S. taxpayer and a bank holding company to own 40 percent of a foreign corporation as opposed to 24.9 of a domestic corporation? Is that a problem?

Mr. PATTERSON. Well, in answering your largely rhetorical question, I obviously have to agree with you that there seems to be an inconsistency there.

Mr. BAKER. Thank you. If you wish to expand on——

Mr. PATTERSON. I was simply going to point out there are many inconsistences under current law in the treatment of banks and bank holding companies in terms of what they can do in this country as opposed to abroad.

Mr. BAKER. Mr. McCoy, you cite the need for empirical evidence with regard to the mixing of banking and commerce in order to make judgments as to how far each step should be taken and, therefore, how many steps.

What more empirical evidence do we need than to look with regard to the unitary thrift charter with over 30 years of experience with hundreds in line now waiting to get their hands on that charter to determine whether there is some inherent risk in the mixing of banking and commerce that has shown it to be inherently more risky to the taxpayer or to the marketplace?

Mr. MCCOY. I am simply a banker and very cautious. That is how I would always state my position. I think there is a lot of information out there that says that we can move forward.

Mr. BAKER. The failure rate of unitaries has not been any better or any worse than any other traditional international institution; is that correct?

Mr. MCCOY. Correct.

Mr. BAKER. Thank you.

Mr. Huber, I don't know if it is still the case, but could you verify whether Aetna still is the owner of U.S. HealthCare's HMO?

Mr. HUBER. Correct, we are.

Mr. BAKER. After the review of your investors—that scrupulous, difficult group of regulators that you cited—looked at the business enterprises in which Aetna is engaged and determined that the ownership of an HMO was not only in the company's best interest, but frankly good public policy. The other information that I have ascertained is that at least in 1996 Aetna's revenues, 14 percent of your stream came from commercial activities.

Under the proposal as we are now contemplating a divesture might be necessary to fall under the revenue limits. Would it serve anyone's best public interest, taxpayer, consumer or otherwise, to force Aetna to divest of U.S. HealthCare's HMO?

Mr. HUBER. Well, I certainly wouldn't think so. And, of course, we were in the HMO business before and that was just really an expansion of our activity in that field.

Mr. BAKER. But your market regulators have found it to be an appropriate mix of business and finance?

Mr. HUBER. Indeed.

Mr. BAKER. Thank you.

Mr. Komansky, there is also considerable discussion about the structure of how securities underwriting should be handled. Do you feel it inappropriate for securities underwriting to be within the op sub of the bank structure or should it be forced out into an affiliate?

Mr. KOMANSKY. No, I don't think it is inappropriate at all. As a matter of fact, we could operate under either structure.

Mr. BAKER. But for an entity which may not have the financial resources or management skill which your company obviously has, would it not be of some economic advantage for the smaller entity to be able to engage in these activities without the cost of the affiliation structure? It might help a competitor.

Mr. KOMANSKY. It might be, it might be.

Mr. BAKER. Thank you. I yield back my time, Mr. Chairman.

Chairman LEACH. Thank you. Before turning to Mr. Kanjorski, because I don't want Aetna's stock to drop, I think it should be very clear under this bill they will not be required to divest their HMO.

Thank you.

Mr. Kanjorski.

Mr. KANJORSKI. Thank you very much, Mr. Chairman.

I guess the observation I want to make is that the banking industry has never been more successful or profitable. We are in a better competitive position than any other industrial Nation in the world with our banking system. We used to hear the argument that bankers needed modernization because they were having their markets sucked away from them. Now we hear in arguments this morning that the securities industry needs it because they are at an unfair disadvantage with banks who are, through regulation, able to participate in activities that the security industry is unable to do.

Why are we here? What is this tremendous compelling interest? Is it the fear that we will not be competitive? Are we about to lose our position economically in the world? We have not yet examined the results of Japan and Germany to know whether mixing commerce and banking may have some fundamental flaws. Have we done away with greed? Have we anticipated that the capacity to mix banking and commerce with the ingredient or disease of greed may cause problems in the future? Has that disappeared? I am not sure that I have overwhelmingly heard an argument here regarding why we have to change.

I tend to agree that if it is not a good change and not good modernization, than we should probably do nothing. We are not necessarily in a disadvantaged position around the world, unless I misread the current bank stock and the securities industries stock reports. Everybody is just filled with money right now.

The other problem that really disturbs me is that in the testimony I heard, nobody addressed the social impact of what this will mean on small- and medium-sized communities as well as the acquisition of small- and medium-sized banks and other businesses. I fear that the unitary thrift charter experiences are not the type of a result that we can anticipate by tearing down the firewalls.

When I supported interstate banking just a few years ago, in a district like mine we went from 60 community banks down to about two. We now only have huge national banks and a few regional banks that are about to be picked up, leaving nothing but very huge national banks. Why isn't it reasonable for me to assume that the same thing will not happen if we allow the banking industry to invade the commerce field? Why will there not be regional banks that become vacuum cleaners of successful businesses and then get

bought up by other entities or join other entities on a much larger scale?

How can I assume that at some point we will not run into the problem that for divestiture purposes we will kill off a company that is financially successful, hires 3- or 4,000 people that are very happy, produces a good product, and for all intents and purposes is doing all the right things that our society and our enterprise system is set up to do, but does not meet the needs of the mergers and acquirers?

Why can we not just anticipate that that is going to be a problem? Where has the testimony been that I have seen in the consolidation of banks in Pennsylvania and throughout the country? Thousands of executives, thousands of managers, and thousands of average people have been let go, and they have now filtered into a strong economy. But, we do not have any studies as to what levels at which they are now employed.

I know several vice presidents of financial service industries that are now doing inventory stocking in major department stores. So, we have not seen any of those studies. Where is the expression of the willingness to be able to engage and expand, as you are all indicating we should? Are you willing to participate, up-train and upscale either your people and see them placed well? How are you going to participate?

Then finally, as you know, we saw a loss of leadership in our communities. When I needed something in my district ten years ago, I could call the bankers together, and we would have 50 or 60 in a room. They would be the leaders, whether it is a United Way Fund, a new school, or whatever we wanted to do. Today I call the bankers together and I am lucky if one or two show up, because there are only five or six there. They are on the road between my place and the next place because they are on their way to corporate headquarters. They really do not give an awful lot to, nor do they know much about the community. It seems to me with this merger we are talking about, in this capacity involved themselves, there are going to be less people on Main Street able to participate in the social leadership fabric of the community.

Now, there will be some efficiencies. There will be some profits. But, what is the weight of the profits to the financial system and to the efficiencies of the economy compared to the disadvantages and losses to the community leadership, to the individuals that work, and to some of the customers that may not be important any more?

That is what weighs on my head, and I hope the next three days of hearings are going to help us get an explanation. I see my time is up, and I yield back, Mr. Chairman.

Chairman LEACH. Thank you.

Mr. Royce.

Mr. ROYCE. Thank you, Mr. Chairman.

You know, in the United States, we have enjoyed a period of time where the financial center worldwide has been in New York. We have had good capital accumulation and a very efficient banking system, but we see this evolution in Europe now, we see the euro, we see the financial services structure there, which has been liberalized to an extent where today firms from overseas, Deutsche

Bank, are purchasing U.S. companies with a special exemption, the exemption that allows commercial banks to be held by a firm that is involved in commerce and involved in securities and involved in insurance and banks.

And in addition we see other exemptions, securities exemptions and so forth, and Deutsche Bank does not have to divest itself of Chrysler or other holdings in the U.S. And it seems to me over time that with what has developed now of especially the euro, you are going to begin to see the type of heavy capitalization that we have had here in the United States, we are going to see a competitive advantage possibly from Europe. And we just begin to see the making—the first wave here of purchases of U.S. banks by firms overseas that are heavily capitalized and are able basically to utilize these exemptions under our laws and under their laws, and then come in and compete with the United States.

And my question is, over time, are we potentially at risk in terms of the financial center moving to London or Frankfurt with the development now of this new synergism in Europe, combined with the advantages that these firms have to compete with the United States, while our own financial services system is in some ways hobbled by the laws that we have put on the book here?

I would just like to hear sort of the long-term forecast from someone on the committee in terms of that problem, or whether you perceive—how big a problem you perceive that could be.

Mr. KOMANSKY. Well, I will take a shot at it. I think many of the threats that you have described are real and they exist today. I don't feel that there is any threat in the immediate future or the foreseeable future, where the United States as a capital market center could be disintermediated in its stature by the European markets.

The main reason for that is not necessarily the strength or weakness of the participants in the financial sector, but because U.S. corporations today represent about 35 percent of total capitalization of corporations around the world.

As long as that type of relationship remains steady, I think it is clear that the United States, including the players in the U.S. capital markets, will remain a dominant market center. At the same time, I do think it is clear that either London, Frankfurt, Berlin or some combination of those places will develop into a heavily centralized market that will compete with the U.S. capital markets vigorously.

If the participants in those two markets are not able to participate on equal grounds, for example, Deutsche Bank being able to acquire Bankers Trust, Merrill Lynch not being able to acquire Bankers Trust, then I think we run the risk of developing much stronger foreign competitors than we have today. But I don't necessarily see it as a threat to the capital markets center being in the United States.

Mr. PATTERSON. I think I would agree with David's last point. London remains one of the most vibrant financial centers in the world. And, yet, most of its most important participants are owned by foreigners. So I am not sure that simply the issue of foreign ownership should concern us. What should concern us is that we enable our institutions to be as strong as they can be and serve

their customers with as full an array of capabilities as possible so that we are stronger vis-a-vis our foreign competitors.

Mr. ROYCE. Thank you, Mr. Chairman.

Chairman LEACH. Thank you, Mr. Royce.

Mr. Watt.

Mr. WATT. Thank you, Mr. Chairman. I appreciate the Chairman having this hearing early in the process so we can try to start working on this problem again. I haven't been here as long as some people, but it does seem like we have all been working on this a long time before I got here and a long time since I have been here and that your comment about wishing the gentleman a long life might be an appropriate one.

Mr. McCoy, I think I am going to direct all of my questions to you. And I hope—I am not doing it to put you on the hot seat, but just because I need some clarification.

Mr. McCOY. I just heard a sigh from the rest of the people.

Mr. WATT. I know there is a tendency—and I don't want to try to separate you from Mr. Leach's bill, he is the Chairman of the committee, and sometimes there is a tendency to try to tie him to a bill that is going to move, and the Chairman's bill, at least as a starting place, is generally the one that people perceive will move, but a lot of what you had to say seems to suggest to me that there is some aspects of the Chairman's bill that you just as soon be closer to the bill that Mr. LaFalce, the Ranking Member, may have introduced already. Did you already introduce—or maybe in the process of trying to develop——

Mr. LAFALCE. It will be H.R. 665.

Mr. WATT. Let me try to zero in on a couple of those things, and without——

Mr. LAFALCE. Mr. Watt, shortly, I would hope to in principal part become a part of H.R. 10.

Mr. WATT. ——Without alienating your affinity for the Chairman's bill, let me just zero in on a couple of those issues. Is there any reason in your mind that we ought be fighting to protect just the holding company concept as opposed to the op sub concept that Mr. LaFalce appears to be going to be making an option in this bill?

Mr. McCOY. I basically believe that we can be supportive either way.

Mr. WATT. So the only reason you were so complimentary of the Chairman then was that he has only one option, and you didn't want to alienate him on that point?

Mr. McCOY. Well, when I wrote my testimony, that was the only option I had.

Mr. WATT. OK. But you would like to have both of them, I take it?

Mr. McCOY. Well, I think that the issue is the concept of H.R. 10 is a very good bill, and we can be satisfied with that. Now, can you make——

Mr. WATT. You endeared yourself to the Chairman in your opening comments. I don't want you to take my time to endear yourself to him any more. What I am trying to find out is whether you would like to have both options available to you, and do you think that is really a better approach to this issue?

Mr. McCoy. I always like to have options. So if both were available, I would take advantage of both.

Mr. Watt. All right. The basket issue. It sounds like to me from hearing and reading your testimony that you are closer to Mr. LaFalce on that issue, you would at least like to have some limited movement toward financial services entities being able to be involved in commerce?

Mr. McCoy. Yes.

Mr. Watt. OK. I thought that is where you were. I just wanted to clarify those two points.

Now, let me turn to the CRA issue, because I want to be clear on what you are saying about that. You basically say that is a subject for another day. We ought to leave that issue alone. But I assume you are not saying that by being silent on CRA in either Mr. LaFalce's bill or Mr. Leach's bill, that we wouldn't be dealing with CRA in some way, just by being silent on it? Were you comfortable with the CRA provisions that were in the bill that left the House Banking Committee last term?

Mr. McCoy. Yes.

Mr. Watt. OK. So I take it your concerns about having a full-blown evaluation of CRA had to do more with what Senator Gramm was talking about than what the bill actually dealt with the last time?

Mr. McCoy. Correct.

Mr. Watt. OK. Thank you, Mr. Chairman. I think my time is up, and I have gotten the clarification on the three main points I wanted.

Chairman Leach. Well, I think I should clarify several points to the gentleman. One, on the bill before us, the Chairman has indicated certain flexibility on the use of language, on the use of the verb—or the use of the adjective complementary, which has enormous ramifications. The Chairman is not very sympathetic to the precept of baskets, which in the view of the Chairman, there has never been anyone who has appeared before this committee at any time.

Mr. Watt. Mr. Chairman, I may not be at odds with you on that. I just was trying to clarify.

Chairman Leach. I want to clarify what is the international interest. In terms of the issue op sub, the Chairman has also indicated a great deal of flexibility, and we have experimented with a number of prospective approaches. We have a number held in reserve. I happen to think Mr. McCoy used an excellent bit of terminology before this hearing when he spoke of splitting the baby. And also when several of the members of this panel indicated an extraordinary frustration that the United States Government can't get its act together, that is something we should expect and that this committee will insist upon.

Mr. Watt. Thank you, Mr. Chairman.

Chairman Leach. Mrs. Kelly.

Mrs. Kelly. Thank you, Mr. Chairman. Before I get into the questions for my first panel I want to take a quick minute to state for the record that I am a strong supporter of H.R. 10 and I will do everything in my power as a Member of Congress and a Member of this committee to see that we pass financial services legislation

for the President to sign. I look forward to working with all the Members of the committee to bring our financial services laws out of the 1930's and into the 21st Century. If we don't pass this legislation America's dominance in the financial services markets will be imperiled, I truly believe.

Mr. Komansky, I recognize the leadership role that Merrill Lynch played some years ago in modernizing the financial services laws, such as the innovative financial products, like the cash management account introduced in the late 1970's and for which Merrill Lynch had to fight in almost every single State at great expense to your company.

It is fascinating to me that the securities and banking industry has had to go ahead and drive change, despite the Federal insensitivity to their needs. Your experience is a legacy of outdated financial services laws. And I think we have got to change that by passing a law that creates a symmetry in the marketplace; however, I am not sure I see anything wrong with the current proposal of H.R. 10.

So I want to ask a question of all four of our panelists. You mentioned in your testimony the mixing of commerce and banking, or some like to say the two-way street. I want to gauge how important that issue really is to all of you. And I am really going to jump off of what Congressman Watt said, I would like to find out if any of you oppose H.R. 10 if it stayed as it now stands without the commercial basket? So I just really want a quick yes or no answer from each of you.

If it stays as it is, without commercial baskets, would you oppose it?

Mr. Komansky.

Mr. KOMANSKY. No, we would not oppose it, provided the flexibility language was still there.

Mrs. KELLY. Mr. Patterson.

Mr. PATTERSON. The same.

Mrs. KELLY. Mr. McCoy.

Mr. MCCOY. I agree.

Mrs. KELLY. Mr. Huber.

Mr. HUBER. We strongly support it.

Mrs. KELLY. So it is an issue but it is not a major issue to any one of you; is that correct? Good. OK.

Mr. Patterson, Mr. Komansky, you spoke about the outstanding issues in this bill really are a few—that the outstanding issues are few and reasonable. And I am quoting Mr. Komansky, but, Mr. Patterson, you also had language to that effect.

As you know, Mr. LaFalce is going to be introducing his own approach, which is described as a more narrow approach than H.R. 10. Are you familiar with what he is going to introduce and would you support it?

Mr. KOMANSKY. I have not studied Mr. LaFalce's bill yet. You can be certain that I will as soon as I get a copy of it. However, I would like to add that when I was talking about the differences being few and narrow, I was talking about the differences that exist within the industries as opposed to what existed before. It does seem to me, as being slightly more than a disinterested observer, that most of the philosophical debate or the chasm that ex-

ists is with the Congress and the regulators. And that was the point that I was trying to make.

Mrs. KELLY. Understood.

Mr. Patterson, would you like to respond to my question?

Mr. PATTERSON. Well, very briefly. Although I haven't seen Congressman LaFalce's bill, I have heard that it includes a basket. Certainly we can support the bill without it. But the Financial Services Council could also certainly support a bill with it. The other aspect of Congressman LaFalce's bill I have heard referred to is that it does achieve a compromise that is supported by at least one of the combatants on the op sub, and I think a compromise is very important to unblock this whole process. If that does serve to unblock that whole process, we can support that compromise as well.

Mrs. KELLY. That would be very refreshing. Thank you very much, Mr. Chairman.

Chairman LEACH. Thank you very much.

The gentleman from Texas.

Mr. BENTSEN. Thank you, Mr. Chairman.

It seems to me that a lot of the—first of all, I appreciate you all being here today, and it is always enlightening and, of course, a lot of the issues that we dealt with last year are the same issues we are dealing with this year.

Mr. Komansky, and actually for both Mr. Komansky and Mr. Patterson, there has been a lot of discussion with respect to the operating subsidiary issue that it is not a safety and soundness question, in fact Mr. Greenspan answered last year that it was not a question of safety and soundness, that had been an argument at one point and every once in a while it raises its ugly head, and I think that has been put to rest. But it is a question of a subsidy, and an implicit subsidy between a bank and a securities operating subsidiary as opposed to an affiliate.

Now, as those who are involved in the capital markets, both among the top firms in the capital markets, do you believe that the market truly would agree that there is some subsidy that adds value to a security of an investment banking firm that was an operating subsidiary versus one that was an affiliate of the bank, that is, would the market look to the security or asset value of a Texas commerce bank security that was in op sub differently than it would if it was an affiliate under a banking holding company?

Mr. KOMANSKY. I haven't thought about it in those particular terms. I would like to have this studied, but intuitively, I would say no.

Mr. BENTSEN. Intuitively, would you think——

Mr. KOMANSKY. I think the market would look through that particular issue and evaluate them fairly equally. I don't think it would assign value to the structure.

Mr. BENTSEN. Mr. Patterson.

Mr. PATTERSON. I agree with that. I think that if the conditions with which either the affiliate or the subsidiary can deal with the bank are the same, that whatever subsidy there is in the bank itself, and that itself is a debatable issue, will not be transferred any more to a subsidiary than to an affiliate, and that the market would recognize that.

Mr. BENTSEN. So that the subsidy would be equal between an affiliate and an op sub in your opinion? Another argument has been made with respect to the difference in determining the asset value between an operating subsidiary and an affiliate. In fact, under the legal structure of an operating subsidiary, say an investment bank, a subsidiary would be treated as an asset of the bank more so than through an affiliate structure of the holding company.

Mr. PATTERSON. Yes.

Mr. BENTSEN.And in the event that there was a—that the bank had financial problems that asset could be liquidated to the benefit of the bank. Do you agree with that, or do you think that the asset value is the same?

This is an argument that Treasury puts forth that in fact the bank has a closer hold of the asset, and thus it improves the balance sheet of the bank.

Mr. PATTERSON. Well, I think that the asset value would be the same whether it was an affiliate or a subsidiary. The obvious difference is that if it is a subsidiary, the asset is included in the consolidated balance sheet of the bank. And if it is a valuable asset, obviously it improves the value of the bank, yes.

Mr. BENTSEN. And finally, and for Mr. McCoy, and I appreciate your endorsement of the operating subsidiary although I understand your reason for saying, you know, any bill is better than no bill. I don't know that that is exactly what you said, I'm sure there are certain bills you wouldn't agree with. But some had suggested and in the Senate or in the other body last year, there was a compromise plan that allowed for an operating subsidiary of an asset for banks with assets up to a billion dollars.

I mean, is there any worth in doing that? I mean, obviously your bank couldn't utilize it. And how many national banks with assets of a billion or less do you truly believe would utilize this versus the other direction?

Mr. MCCOY. I am of the belief that—I don't know how you depict it as a billion or $799 million. I think what is good for the goose is good for the gander and should not have levels like that.

Mr. BENTSEN. Thank you. Thank you, Mr. Chairman.

Chairman LEACH. Thank you.

Mr. Hill.

Mr. HILL. Thank you, Mr. Chairman. And I just want to congratulate this panel on excellent testimony. And what I do hear I think is that as we move closer to the possibility of a bill, positions in the past which were strident to have been softened some by all of you and that perhaps maybe we are getting close to actually being able to do something.

One of the concerns I have, I have some concerns about this operating subsidiary issue with regard to risk taking subsidiaries, because that creates an environment where liability can migrate and also profits migrate. And my concern is specifically really with regard to the insurance industry.

The solvency of the insurance industry is substantially regulated at the State level, and in many instances the State regulators use the assets of parents and affiliates to determine the level of risk they are willing to allow the insurance companies to take.

Do you believe, and I would ask each of you to respond to that, do you believe that there is risk to undermining the solvency of the insurance industry if insurance underwriting activities are allowed to occur in operating subsidiaries?

Mr. HUBER. Well, I guess I am surprised I am the first one. I think the risk is certainly containable, manageable, under the present structure of State regulation. There is always risk. But I think that it would be no greater than it is today. The structure of the State solvency regulations work pretty well, and they would presumably still apply.

Mr. HILL. You guarantee the solvency of some of your subsidiaries to insurance regulators?

Mr. HUBER. Correct.

Mr. HILL. If you are a bank and prohibited from doing that by the comptroller, would that impact your—the attitude of insurance regulators with regard to solvency issues?

Mr. HUBER. Typically when we guarantee the capitalization of a subsidiary, it is for capital efficiency. I always have the option of putting the money there. But in many cases, it is more capital efficient to be able to give a guarantee to the State regulator of the State of Maine or the State regulator of the State of Pennsylvania. But the option of fully capitalizing is always there. So I don't think it is a major issue.

Mr. HILL. Mr. Huber, I found your testimony with regard to Mexico really interesting. Can you offer same or similar services to customers in other countries at relatively lower costs than you can to the United States by virtue of more flexible powers with regard to affiliation?

Mr. HUBER. Most certainly. As I say, it is a very efficient distribution system, and I would love to be able to offer the same products to Mr. McCoy, a bank. I mean he has a wonderful branch network and it would be a way to access what in most of our overseas operations are totally untapped markets. It lies under the radar screen of the traditional agency force.

Mr. HILL. Generally people use examples such as Japan, Germany, Switzerland, you used the example of Mexico, as examples where more flexible affiliation has created a more vital market. Are consumers in those nations able to buy insurance services at lower costs as a consequence of that?

Mr. HUBER. Well, as I say, I think that they are able to buy, particularly the plain vanilla or basic cable type of products. Typically when they want a more sophisticated product, they do need the hand holding or the advice of a qualified agent or adviser. And so we see it really as a continuum, but certainly at the lower level, and this to me is really quite exciting. We are tapping a market that is underserved today or unserved, and I think it would be the same in this country.

Mr. HILL. In your earlier comments, you made the reference to the fact that you are not particularly a fan of State regulation of insurance. I certainly believe H.R. 10 does lay the foundation for ending the State regulation of insurance, which I have some concern about. I guess I would ask you, do you have any concern that the current structure of H.R. 10 actually is going to create more regulators of insurance rather than fewer, because obviously the

Fed would have a role and if operating subsidiaries become a reality, then the Comptroller would have a role, and then the insurance regulators would have a role? Does that concern you some?

Mr. HUBER. I didn't want to leave the impression that I am against State regulation; it works quite well now, and we live comfortably within it. We would hope that whatever happens that one would preempt the other. I really would pray not to have another whole new layer of regulators. We have more regulators than Carter has little liver pills already. And so another layer would be counterproductive. That is the only request.

Mr. HILL. Let me just ask one last question, with regard—there is a Senate bill that does not include a definition of insurance. Do you think that that is a good idea or a bad idea?

Mr. HUBER. I have to opt out. I am not familiar with that bill.

Mr. HILL. Thank you, Mr. Chairman. Thank you, Mr. Huber. I thank the panel.

Chairman LEACH. Mr. Sherman.

Mr. SHERMAN. Thank you, Mr. Chairman. I would like to announce I am the weak supporter of H.R. 10. I hope we are able to improve the bill, so that it is something that we can all vote for. Glass-Steagall was a reaction to the problems of the 1930's. And I think that this bill still remembers the lessons of the 1930's. I wasn't around for those. But as a Californian, I was around for the lessons of the 1980's and Mr. Charles Keating, and I would like to focus on the consumer protection aspects.

What happened with Charles Keating is that people walked into financial institutions that for half a century they had been told were guaranteed by the Federal Government and were moved from the new accounts desk to the investment desk and invited to buy the subordinated debentures of the financial institution itself. And that raises two lessons. The first is the separation between the new accounts desk and the financial securities desk or the insurance desk, but the other is also selling your own securities.

I would like to address this to Mr. McCoy. Do you see it as a desirable provision of financial reform that a bank is prohibited from selling its own equity or debt securities other than either regulated insurance products from one of its affiliates or, of course, of its own certificates of deposit?

Mr. MCCOY. I would think that generally it was prohibited. It would not be a bother to me—I understand where the issue is coming from. If I could comment, one of the interesting things to me is we always talk about the old brick and mortar, today the consumer can go on the Internet and have really no idea who he is dealing with, can buy securities, can open a checking account that really isn't a checking account, it is coming from Fidelity, somebody else.

So I think that, you know, that the issues are bigger than whether the account desk is here or there, and I think there is a whole new issue out there.

Mr. SHERMAN. I understand, although, when I think of the people that we are trying to protect, an awful lot of people, baby boomer and younger, are aware of all of the different investments that are out there. But a huge portion of the wealth, particularly the wealth invested in long-term certificates of deposit is held by peo-

ple 80-years-old or older, many of whom who are not on the Internet and who had have 80 years of experience—well, 50 years of experience with our current financial situation and by conditioning believe that when you walk into a depository institution, that everything you buy there is federally insured.

And I agree with you that we may not be able to create separate offices with brick and mortar. The last time I was in a depository institution, the same new accounts person walked me from one desk to the other desk, it was all of 10 feet, and offered me a variety of uninsured products. I thought they were suitable and that was fine. But I do think that we have got to go for the strongest possible written statement signed by the consumer saying a full understanding that these securities could go up and down, and they are not insured by any agency of the Federal Government.

I am troubled by language that says not insured by FDIC as if—that almost implies, yes, it is insured by some other Federal agency. And I think a very bold, very short, huge nobody-would-have-to-put-on-their-glasses-to-read statement may be criticized by the industry as being prerogative. But I think we need words like "not insured by anyone," "could decline in value" in very large letters.

Thank you.

Chairman LEACH. Well, thank you, Mr. Sherman.

Mr. Inslee.

Mr. INSLEE. I will pass, Mr. Chair.

Chairman LEACH. Mrs. Jones.

Mrs. JONES. Mr. Chairman. If I use the microphone, it would help. Thank you, Mr. Chairman, to the presenters. I was here for a little while, had to leave out, I guess that is what all Congresspeople do. This is my first time in Congress. The name is Stephanie Tubbs Jones. I am from Cleveland, Ohio. I am the successor to Lewis Stokes.

I have a couple of questions only because even though the issue or this discussion is very old to all the Members of Congress, it is very new to me, a new Member of Congress, and so I ask you to bear with me as I ask a few questions.

To Mr. McCoy, I want to turn you to page 4 of your testimony with regard to the consumer privacy, and ask you when you say that having the comprehensive consumer privacy provisions would impact consumers banks, the entire national and international economy, can you give me some examples of what you mean by that statement?

Mr. McCOY. Let me just look at it here.

Mrs. JONES. Sure.

Mr. McCOY. Basically, what I am concerned about is there are a number of things regarding privacy where I think that because we have information about the customer, we can provide him with even better services as opposed to fewer services. And so if we put in strict controls in certain areas, I think we are going to hurt the consumer, hurt his capability to get the right product at the right time. So that is an example of that.

Mrs. JONES. And then that will affect the economy?

Mr. McCOY. If we introduce inefficiencies into the economy, it will affect the economy. If we do not give the best product to the

customer, if we are not as competitive, it will have an effect on the economy.

Mrs. JONES. I want to follow up with my colleagues' question with regard to consumer notification. The other thing that I would raise with regard to people going on the Internet. There are a lot of people out here with very little money who don't have an Internet, who don't know how to access that information, and I represent a number of them from the 11th Congressional District. So I have to speak up and speak out on behalf of them with regard to issues of notification. And much like my colleague, there are a lot of people who don't understand the distinction.

We operate—or you operate—the banking industry with—they don't even understand what the word subsidiary means. And so those of us who are in a position to safeguard their interests have to speak up about notification.

I did have one more question for you. It is not that I am picking on you, you just provided the best testimony for me to ask questions. Let me see, where was my additional question? Give me one second. Oh, I know. And I know that my colleague, while I was out of the room, Mr. Watt, raised the issue about the CRA. It is important for me as a Representative of the City of Cleveland, recognizing that you say you have had a good history with CRA, BANK ONE has had a good history with CRA, that as we change the face or we modernize banking that CRA is always a part of the modernization, because it is as a result of the people who have been the mainstay in our Cleveland communities that you are able to even think about the modernization to the extent that they have held down the cities on all of our behalfs.

So I would encourage you and all of you involved in this process to not allow CRA to go to the side. It is the community that allows you the opportunity to operate, and I just want to be heard on the record with regard to that.

Mr. Chairman, thank you very much.

Chairman LEACH. Thank you for that thoughtful observation. If I could, John, if I can go to Mr. Ryan and then to you.

Mr. Ryan.

Mr. RYAN. Thank you very much. I would like to direct my question to Mr. Huber and maybe Mr. McCoy as well. I was intrigued with your testimony on what you have done in Mexico and for other countries with financial modernization. I would like to talk about what life will look like afterwards.

You were able to bring tools of wealth creation to lower and lower middle class Mexicans and other people of other countries. Where I live, in southern Wisconsin, we have—I have quite a constituency of lower and lower middle class Americans. And I can't help but seeing Mr. McCoy there thinking of Gary Rilly, the local BANK ONE president of the branch in Janesville, Wisconsin, well respected member of the community, participates in the YMCA. It is an area where people know they can go and access products, but there are a lot of lower and middle class Americans who don't believe they have access to these tools of wealth creation.

I would like for you to address the point on how you think the barriers for offering these tools of wealth creation to individuals in

America would be relieved, and what would your company structure would look like after financial modernization?

Mr. HUBER. Well, as I mentioned before in talking to Mr. Hill, we would see that using the branch network of a retail oriented bank would be a very efficient channel of distribution, one which we have used in other marketplaces. And we typically find in emerging markets, and many of our communities would be defined as emerging markets, the first financial services product that an individual buys when he or she breaks into that lowest level of the lowest part of the middle class, is life insurance.

And, typically, they are relatively small policies, sometimes they are the equivalent of $2 a week or something like that. And they don't—they are really not serviced today. To the agent, it is just not attractive business. So the ability to be able to have it available and service that population through a branch network to me is a very appealing opportunity.

And I guess I should add one other thing about Mrs. Jones' comments on disclosure. I mean we have the most confiscatory financial instrument known to man out there called lottery tickets. And if you want to have financial disclosure, why don't we put on lottery tickets that "you have one chance in a million."

Mrs. JONES. If you would allow me, Mr. Chairman, everybody knows their chance on winning a lottery ticket, and sometimes it is better than in other institutions, but I will laugh with you on it.

Mr. HUBER. I am not sure. Sorry, Mr. Ryan.

Mr. RYAN. Thank you. Thank you, Mr. Chairman.

Chairman LEACH. Well, thank you, Paul.

Mr. LaFalce.

Mr. LAFALCE. I thank you, Mr. Chairman. I think the panel will be finished as soon as we recess for this vote, and then I have a press conference. Let me just make a couple of brief points, Mr. Huber. First, I am talking about 20 years ago, and when I introduced in the late 1970's a uniform product liability bill that was strongly opposed at that time by the United States Chamber of Commerce and the dissenting opinion to my report was written, amongst others, by Dan Quayle, a Member of my committee at the time, which shows how positions can evolve over the years.

At the same time I introduced that product liability bill, I introduced the Federal Insurance Commission, which could not have duplicate regulation, but had the capacity when there was deficient State regulation and appropriate State regulation to preempt the field, and I have suffered for the introduction of that bill from that time to the present.

Let me say something else too. I will be introducing a bill shortly at a press conference, H.R. 665. It is my hope and desire and intention that there never be a vote on that bill on the floor or in committee. It is my hope that whatever areas of disagreement, small as they are, that exist between Chairman Leach and myself at present, it can be compromised away before we get to a committee mark, so we can have some improved and enhanced and consensus brought by a partisan consensus version of H.R. 10.

The Chairman said something today that he has a fallback position with respect to operating subsidiaries. I heard that loud and

clear, and I assure him that on any issue where there is a difference of opinion, I too have a fallback position certainly with respect to the whole position of banking and commerce, and I look forward to working together.

One thing I was thinking of as we were sitting here, gee, what if a bill didn't address the question of operating subsidiary at all and didn't address the question of a basket at all, but didn't make any changes in existing authorities, you know, for any present charter or any present regulator either, but made all the other changes that are being talked about? That might not be a bad bill.

I thank you.

Chairman LEACH. Well, thank you. I want to thank the panel. I think we have gotten off to a strong start, and I just want to emphasize that even though some differences were expressed today, that the overwhelming outcome is one of consensus, rather than dissent. And sometimes as you discuss differences one gets the emphasis on difference, but I think I am correct in sensing a great consensus.

We have a vote on the floor. I am told we might have one to shortly follow it. So for the sake of the next panel, I would like to leave a precise time so people can arrange for lunch, and so we will recess until 1:30. I want to thank all of you.

Mr. HUBER. Thank you.

[Recess.]

Chairman LEACH. The hearing will come to order.

I had hoped for a few more Members of the Minority to be here, but they are at a press conference and will be here shortly. At least one member of your panel has a commitment, and I thought we would begin based on that circumstance.

Our first witness will be Roy J. Zuckerberg, who is a Limited Partner of Goldman, Sachs and Chairman of the Securities Industry Association.

Our second witness is Mr. R. Scott Jones, who is Chairman and CEO of the Goodhue County National Bank of Red Wing, Minnesota. Mr. Vento has welcomed you earlier in your absence. I would like to say, as a resident of greater northern Iowa, we welcome you, too.

Our third witness is Mr. William J. McQuillan, who is Chairman, President and CEO of the City National Bank of Greeley, Nebraska, and President of the Independent Bankers Association and a resident of greater western Iowa. We appreciate that as well.

Our fourth witness is E. Lee Beard, who is President and CEO of the First Federal Bank of Hazleton, Pennsylvania, and Chair of America's Community Bankers. Our next witness will be Matthew P. Fink, who is President of the Investment Company Institute; and our last witness for this panel will be Michael P. Smith, who is President of the New York Bankers Association.

Chairman LEACH. Mr. Zuckerberg has a commitment, and we appreciate his staying with us. We will begin with you, sir.

STATEMENT OF ROY J. ZUCKERBERG, LIMITED PARTNER, GOLDMAN, SACHS & CO., AND CHAIRMAN, SECURITIES INDUSTRY ASSOCIATION

Mr. ZUCKERBERG. Thank you.

Mr. Chairman and Members of the committee, I am Roy Zuckerberg, Chairman of the Securities Industry Association and a limited partner of Goldman, Sachs. I appreciate the opportunity to present SIA's views on H.R. 10, the Financial Services Act of 1999.

SIA commends you for your steadfast determination to enact this much-needed legislation to modernize the regulation of the U.S. financial services industries. We applaud your continuing leadership in reintroducing H.R. 10 so soon in the legislative session.

Mr. Chairman, my message today is a simple one. The securities industry strongly supports financial services modernization legislation and urges this committee, the House and the Senate to pass it promptly.

When the House passed a similar version of H.R. 10 last year, it faced and resolved many of the contentious issues that have stopped financial services modernization legislation. The bill's many compromise provisions developed over years of negotiation amongst securities, banking and insurance trade groups gave it broad industry support.

SIA supports key provisions of H.R. 10 because they go a long way toward meeting three principles upon which any financial modernization legislation should be built: one, functional regulation; two, a two-way street; and, three, competition without Federal subsidies.

H.R. 10 creates a new regulatory structure that would enhance the competitiveness of financial services firms by permitting securities firms, insurance companies and banks to freely affiliate in a holding company structure. Increased competition between financial services firms will reduce costs, give customers more choices and help the U.S. financial services industry maintain its preeminent status in the global economy, something we should be very proud of.

Today financial institutions are affiliating with one another at a dizzying speed under a regulatory system that was intended to ban such affiliations. In the last two years alone, banks have acquired at least 50 securities firms. Mergers and acquisitions are occurring in spite of significant and anti-competitive regulatory obstacles. For example, currently banks can acquire security firms, while security firms generally cannot acquire commercial banks.

The financial services industry will continue to evolve in response to customer demands and to remain competitive. It is simply not desirable or possible to maintain the status quo. The fundamental policy question for Congress is not whether these affiliations should occur but what regulatory system should govern the combined entities. Surely, it should not be the current patchwork regulatory scheme that gives some financial institutions unfair and irrational competitive advantage over others. SIA believes these combined entities should be regulated under a system similar to that proposed in H.R. 10.

The U.S. securities industry is perhaps as competitive as any industry in the world. That competition, including the ability to affiliate with entities other than banks, is one reason why the U.S. capital markets are the world's largest and most liquid. In the securities markets, one need only look at the vast choices in products,

services, providers and methods of compensation to see how competition has greatly benefited investors.

H.R. 10 would expand those choices. Individuals and corporate customers worldwide could have all their financial needs met by a single firm if securities firms, insurance companies and banks were allowed to affiliate. SIA's first principle, functional regulation, would require one regulatory agency to apply the same set of rules to the same activity engaged in by any financial institution regardless of the type of institution it may be.

Under H.R. 10, all securities activities would be performed outside of a bank except for a small number of carefully defined securities activities that traditionally have been conducted in banks with the benefit of SEC, SRO and State securities regulation.

Second, the legislation generally provides for a two-way street by permitting securities firms, insurance companies and banks to freely affiliate with one another on the same terms and conditions and to engage in any activity that is financial in nature.

Third, H.R. 10 provides that all securities and insurance activities must be conducted in separately capitalized affiliates of a bank rather than in the bank itself. As a result, these activities would not pose a risk to the deposit insurance system and taxpayers would not be forced to indirectly subsidize banks that engage in those activities.

SIA also supports other key provisions in H.R. 10. For example, H.R. 10 would create wholesale financial institutions which are banks that do not accept federally insured deposits, that is, they generally do not accept deposits under $100,000. WFIs would provide commercial banking service to institutional customers without imposing any risk to the bank insurance fund or U.S. taxpayers.

Mr. Chairman, last session SIA supported H.R. 10 and worked actively to pass it. That bill represented a series of compromises by every sector of the financial services industry. We supported the bill because we were and are committed to maintaining the delicate consensus compromise that emerged from all the participants.

However, as in years past, there are several areas of the bill that SIA continues to believe could be improved. Most importantly, this would include providing securities firms with greater flexibility to affiliate with banks even if they have nonfinancial activities. My written statement contains a more complete discussion. The changes, we believe, would make H.R. 10 more valuable to investors, consumers and the industry.

SIA worked with you, Mr. Chairman, with Members of the committee, others in Congress and many in the financial services community to reach a number of the compromises that were reflected in H.R. 10. The progress you made cannot be overstated. Passage of financial services modernization legislation has long been SIA's number one legislative goal. As of today, no other legislation has been introduced that meets our principles to the extent H.R. 10 does.

We look forward to working with you, Members of your committee as well as the House, Senate and Administration to enact financial services reform legislation this year. The most important priority for us is getting the legislation enacted.

Thank you very much.

[The prepared statement of Roy J. Zuckerberg can be found on page 310 in the appendix.]

Chairman LEACH. Thank you, Mr. Zuckerberg.

Mr. Jones.

STATEMENT OF R. SCOTT JONES, CHAIRMAN AND CEO, GOODHUE COUNTY NATIONAL BANK, RED WING, MN, AND PRESIDENT, AMERICAN BANKERS ASSOCIATION

Mr. JONES. Mr. Chairman, thank you for introducing H.R. 10 and holding these hearings so early on in this session.

As we all know, the road to financial reform has been long and difficult. Real progress has been made, however, thanks to your leadership and the efforts of many on this committee. The fast start in this committee and in the Senate certainly boosts the chances for success. H.R. 10 reflects the growing consensus that emerged last year, and we believe it is the right place to begin the debate this year.

As a banker, I need to offer new products and services to meet the changing needs of my customers. Let me give you a personal example from my town of Red Wing, Minnesota, population of 16,000 people.

Back in the 1980's a popular product was single-premium, fixed-rate annuities. We couldn't offer that product as a national bank. Because we couldn't offer this key product, we lost business. More important than that, we lost relationships with some of our key customers. It affected our growth and, therefore, our ability to serve the local economy.

Because we were worried about serving our community, we petitioned the OCC for permission to sell annuities, and we got that permission some two years after the petition was sent in. Now, nine years later, our ability to offer annuities has helped us build our customer base and, therefore, be able to serve our community.

Now I face the same dilemma I faced eleven years ago today. Because we can't offer customers the products they want, many are taking their business to other providers; and in today's fast-paced world, we can't wait for two years for approval to offer these products. Our customers need them today, and we need to act now. We simply must move forward on financial reform. With each passing day, the market gets further ahead of the regulatory structure.

Also, this may be the last chance to deal with the commercial ownership of banks through unitary thrift holding companies. H.R. 10 represents a compromise on unitary thrifts but one acceptable to the ABA, and it is important to note that America's community bankers supported a bill last year that contained this provision.

For many banks and particularly community banks, the unitary thrift issue is critical. The crux of the unitary thrift issue is whether to mix banking and commerce. If Congress does not make a decision soon, the marketplace will make it for us, and we will have permanently crossed the bridge into full banking and commerce.

For example, Microsoft could buy a small thrift with their spare change, merge it with a large bank and run the combined firm as a unitary thrift. While technically having a thrift charter for all practical purposes, it would, of course, be a bank.

And that is the critical point. There is very little, if any, difference between a bank and a thrift. However, there is a big difference in how their holding companies are regulated. For example, no capital standards are imposed on parent holding companies of thrifts. By not dealing with the unitary thrift issue, Congress will have blessed two parallel banking systems, one with a much stricter regulatory standard than the other, and we know that basic economics tells us the flow of capital will move to the lesser regulated entity.

In fact, interest in thrift charters by nondepository firms is growing rapidly. Large companies like ADM, Nordstrom and General Motors are among 70 nondepository firms who have recently sought a thrift charter.

Let me touch on a few other important provisions in H.R. 10.

First, we are very supportive of the securities provisions in this bill. As you know, a lot of people, including Members of this committee and the ABA Securities Association, have worked long and hard to develop a consensus.

Second, the treatment of insurance has been one of the most troublesome issues in financial services reform over the years. The current version of H.R. 10 strikes a balance, we believe, and is based on negotiations last year between the ABA in partnership with the New York Bankers Association and others. Never before had the Independent Insurance Agents of America and the banking industry been able to reach a compromise. But we did last year, and that is significant.

Lastly, we are pleased that H.R. 10 contains several positive Home Loan Bank provisions. As you well know, Mr. Chairman, in rural communities it is becoming increasingly difficult to attract resources for servicing the capital and loan needs of small rural communities. These provisions will help in this regard, enabling banks to do a better job of serving their communities.

Thanks to the work of this committee, we are on the verge of enacting thoughtful financial modernization reform; and we look forward to working actively with you to see its passage.

Thank you.

[The prepared statement of R. Scott Jones can be found on page 322 in the appendix.]

Chairman LEACH. Thank you, Mr. Jones.

Before turning to Mr. McQuillan, I have to inform you that there is another vote on the floor; and so the hearing will be in recess subject to the vote.

[Recess.]

Chairman LEACH. The hearing will reconvene.

Our next witness is Mr. William McQuillan. Please proceed.

STATEMENT OF WILLIAM L. McQUILLAN, CHAIRMAN, PRESIDENT, AND CEO, THE CITY NATIONAL BANK, GREELEY, NE, AND PRESIDENT, INDEPENDENT BANKERS ASSOCIATION OF AMERICA

Mr. MCQUILLAN. Thank you, Mr. Chairman and Members of the committee.

I am Bill McQuillan, President of the Independent Bankers Association of America and President and CEO of the City National

Bank in Greeley, Nebraska. Thank you for inviting the IBAA to testify today on H.R. 10.

Before getting into the specifics of H.R. 10, I would like to underscore the fact that this bill will clearly authorize the common ownership of the largest banks, security firms and insurance underwriters in the United States. This enormous public policy shift has been largely overshadowed by other controversial sections of the bill.

The merger and acquisition wave which this bill would accelerate is already having an anti-competitive effect on ATM networks and credit and debit card markets. Citicorp announced that it will no longer promote the Visa and MasterCard brands. This decision hurts thousands of community banks, thrifts and credit unions trying to enter the credit and debit card markets and offer competitively priced electronic products at a fair price to their customers. Will other big card issuers follow? We believe, unfortunately, they will.

Let me now turn to the specifics of your bill, Mr. Chairman. I want to commend you for building on the progress that we made last year by introducing a bill substantially similar to the one that almost passed the Senate.

The IBAA policy body has developed seven standards by which financial modernization bills will be judged. First, the IBAA will oppose any legislation that permits or encourages the common ownership of commercial banks and commercial firms. Last year, before the Asian crisis, this committee supported such a proposal. In their most recent testimony before the Senate Banking Committee, Chairman Greenspan and Secretary Rubin did not.

Proponents of such common ownership try to sugarcoat this bitter pill by putting in revenue and/or size limitations. One proposal would limit such ownership to commercial firms whose revenues provided less than 15 percent of the total revenues of the resulting conglomerate. If there were no such limitations, this 15 percent basket would permit Bank of America to buy Apple Computer or WorldCom.

With the size limitation, the door would still be open for the largest commercial banks to buy many small businesses. These are paths we should not go down, Mr. Chairman. They are anticompetitive or distort the impartial allocation of credit and would threaten the safety and soundness of our banking system and lead to crony capitalism.

We commend you, Mr. Chairman, not only for keeping banking and commerce out of the bill you introduced but also for your very strong statement of January 20th regarding a bright line in the sand on this issue.

Second, the IBAA cannot support and will oppose any legislation that has not closed the unitary thrift holding company loophole. This loophole allows any commercial firm to get into the banking business by buying a unitary thrift. Closing the necessary thrift loophole has been a bright line test for banking industry support of banking legislation. Chairman Greenspan has recommended that a moratorium be placed on such applications.

May we remind the committee in 1996 the banking industry put billions on the table to capitalize the save and help pay for FICO.

Please do not allow the unitary thrift loophole to again create a parallel banking system supervised by the OTS. We support the language in your bill, Mr. Chairman, that closes this loophole prospectively and further prohibits grandfathered thrifts from being sold to a nonfinancial firm.

Third, we also believe that any financial modernization bill must include provisions for meeting the funding and liquidity needs of community financial institutions. The Federal Home Loan Bank reform language in your bill, Mr. Chairman, meets this test.

Fourth, any financial modernization bill should include new retail powers for national banks. These should include, within the parameters of safety and soundness, insurance agency powers and the power to sell mutual funds and annuities.

We would view any rollback of an existing authority as anti-competitive. Regrettably, our most recent analysis of the insurance language in H.R. 10 suggests that the banking insurance powers would indeed be rolled back, making it more difficult for community banks to enter the insurance business in the future.

Additionally, H.R. 10 would remove the judicial deference of the OCC with respect to insurance sales authority under the National Bank Act.

Fifth, of paramount concern to the IBAA is a protection of the deposit insurance fund, which is the lifeblood of our community banks. This fund must be protected from being raided should a huge financial conglomerate collapse. For that reason, there should be a maximum insulation of risky activities conducted in a financial conglomerate from the commercial bank component.

We support the provision in your bill that prohibits bank subs from engaging in certain activities not permissible for national banks to engage in directly, such as insurance or securities underwriting, real estate investment or merchant banking. Let me add a few IBAA members would be clamoring to enter those markets. Or if the fund is rated to bail out a conglomerate, our members will be asked to help to pay replenish the fund. And we do not think that is either fair or good public policy.

Sixth, we strongly support the provision in your bill, Mr. Chairman, that designates the Federal Reserve as the umbrella regulator for diversified financial services firms.

Seventh and finally, Mr. Chairman, we support each and every consumer regulation that does not discriminate against banks.

In addition to these seven guiding principles, IBAA is concerned about the creation of WFIs. WFIs would have access to the Federal Reserve System's payment services, breaching the secure walls of the payment system that is so vital to community banks. WFIs also could be exempt from banking regulations, having the effect of creating a new and superior banking charter. These are major policy shifts that we believe should be further explored.

In conclusion, Mr. Chairman, we would recognize the enormous commitment of you and others that nearly resulted in the financial modernization bill being enacted in the last Congress. We appreciate your building on that progress. We look forward to working with you, Mr. Chairman, and others on this committee to find a product that meets the principles outlined in our testimony and warrant our support.

Finally, I would like to, if the Chairman would allow me, enter into the record a letter that we sent to the Senate side last year basically outlining our opposition to the unitary thrift and the issues that were are going on over there. We felt that ABA and IBAA could not support that issue. We sent a letter to Chairman D'Amato last year and also to Senator Sarbanes. I would like to enter that as part of the record to show our support in opposing the unitary thrift. Thank you.

[The prepared statement of William L. McQuillan can be found on page 356 in the appendix.]

Chairman LEACH. Without objection, that letter will be presented in the record; and, without objection, the lengthier testimony of all witnesses will be put in the record as well.

Chair Beard.

STATEMENT OF E. LEE BEARD, PRESIDENT AND CEO, FIRST FEDERAL BANK, HAZLETON, PA, AND CHAIR, AMERICA'S COMMUNITY BANKERS

Ms. BEARD. Good afternoon, Mr. Chairman. My name is Lee Beard. I serve as President and Chief Executive Officer for First Federal Bank in Hazleton, Pennsylvania. I am also fortunate enough to serve as the chair for America's Community Bankers, and that is the capacity in which I speak to you today. First Federal is a $520 million asset institution which is held by a unitary savings and loan holding company. I am the unitary thrift.

ACB appreciates this opportunity to testify on financial modernization legislation and specifically on H.R. 10. We share your hope stated in your letter of invitation that the 106th Congress will agree, and I quote, on legislation to provide a framework where the banking, securities and insurance industries compete at an optimal level of efficiency and effectiveness while providing consumers, and that is an important point, access to the broadest range of financial services and products.

In our opinion, the best way to reach that goal is to preserve the best elements of the current financial system and then expand opportunities to others that have been held back for years by Depression-era laws. And today we think that there is no better model for financial modernization than the business flexibility found in the thrift charter and holding company.

Financial modernization should provide the flexibility for institutions to adapt to the rapidly changing marketplace and to structure the delivery of financial services to their customers in the best possible way. This principle of freedom to choose is very important. I think it is important that I give credit where credit is due. While those are certainly the comments of the ACB, they are actually reflected in page 9 of the testimony of the ABA.

One example that might be important to you is my own institution, First Federal Bank. We decided to organize a unitary thrift holding company after carefully evaluating the needs of our local market and customers, deciding that a new direction would be the best way to grow and to serve our community. The flexibility of the charter and its unitary structure allowed us to purchase a title insurance agency subsidiary known as Abstractors, Inc.

This company provides title searches and real estate settlement services in Northeast Pennsylvania. Abstractors provide services not only to First Federal Bank customers but to customers of other banks and financial companies. We are also seeking a license to offer trust services through another holding company subsidiary.

At the same time, there are appropriate tradeoffs for this flexible holding company arrangement. We are required to maintain our commitment to homeownership and to consumer lending. Our commercial lending authority is actually restricted, and we undergo the strict regulation of both the OTS and the FDIC. Still we make this choice not because of Government dictates but because our local market says it is the right thing to do.

Business flexibility works in Northeast Pennsylvania and throughout the United States. Modernization legislation should expand this flexibility throughout the financial industry.

Our customers do not care if we are a bank or a thrift. They do not come and ask what our charter is. They talk to us about what products we offer, what risks they take, how we provide the service and how we price our products.

While H.R. 10 does make some major improvements, such as permitting banks to freely affiliate with securities and insurance firms at the holding company level, it also does substantial harm to national banks, thrifts and the 875 existing unitary thrift holding companies, which includes First Federal Bank.

H.R. 10 would take away many of the unitary thrift holding company affiliation rights for companies that had not applied for a charter by October 7th, 1998. While some firms might be satisfied with the improvements in the bank holding company structure provided in H.R. 10, others might not, and some might not even qualify for a bank charter. There is no reason to pick an arbitrary date on which to cut things off.

Second, H.R. 10 would prohibit existing thrift holding companies with nonfinancial affiliates for merging with other firms, with the small exception of mergers among the limited number of grandfathered thrift holding companies with nonfinancial affiliates. All other firms would be barred by law from acquiring a grandfathered thrift holding company.

These artificial constraints on mergers, acquisitions and divestitures would only serve to decrease the franchise value of existing holding companies and reduce economic efficiency without any corresponding public policy justification.

Those who claim these limits are based on concerns about mixing banking and commerce are actually wrong, in our opinion, because the commercial lending of thrifts is strictly limited. They may not lend to commercial affiliates under any circumstances. Thrift holding companies do not mix banking and commerce.

Remember that much of our institution's economic value is based on what our charter allows us to do today. H.R. 10 would undermine the uniform Federal standards under which our institutions can offer lending and deposit-taking services. H.R. 10 imposes an additional burdensome notice and comment process whenever the OTS seeks to implement such standards.

For these reasons, and for many others, ACB urges the committee to rethink its approach to financial modernization and to write

a bill that will provide new competitive options for financial firms without reducing or eliminating the ability of firms to provide competitive products and services.

I thank you, Mr. Chairman for the opportunity to testify; and I would be happy to answer any questions.

[The prepared statement of E. Lee Beard can be found on page 370 in the appendix.]

Chairman LEACH. Thank you, Ms. Beard.

Mr. Fink.

STATEMENT OF MATTHEW P. FINK, PRESIDENT, INVESTMENT COMPANY INSTITUTE

Mr. FINK. Thank you, Mr. Chairman. I am Matthew Fink, President of the Investment Company Institute, which is the national association of the mutual fund industry. I am pleased to be here today to testify in support of your bill H.R. 10. I would like to commend the committee in general and you, in particular, Mr. Chairman, for your efforts in leading the effort of financial modernization.

Last year this committee, working with the House Commerce Committee, reached historic compromises on issues that have been divisive for decades. I think that unprecedented action last session spoke very powerfully. It is now clear to all of us that the laws that have historically separated banks, securities firms, mutual fund companies, and insurance companies are now obsolete, and we think H.R. 10 represents a very sound framework for addressing financial services reform.

First, and most obviously, it permits affiliations among all types of financial services companies. Second, in the mutual fund area, it would grant commercial banks full mutual fund powers. Third, in the mutual fund area, it would modernize the Federal securities laws to deal with bank mutual fund activities. Fourth, it would generally, and I want to emphasize the word generally, implement the oversight system based on a sound system of functional regulation. So those are the four reasons we support the bill.

In that spirit of support, I would like to mention three issues that we would hope the committee could address as you move along. The first is an issue that only became apparent in the closing days of the last Congress. And I am happy to report it is an issue that no one else has mentioned today, so maybe it will add a little more spark or life than some of the other issues. The issue is to ensure that functional regulation, which everyone agrees with, is applied to all, not just some, of the bank regulatory agencies.

More specifically, if you look at H.R. 10, it has the proper standards for governing the powers of the Federal Reserve Board and the FDIC as functional regulators. But the same has not been done with respect to the Comptroller of the Currency and the Office of Thrift Supervision.

Let me start by asking: "Why is functional regulation so important?" Mr. Huber on the early panel this morning discussed functional regulation, and he gave one very important reason; you don't want multiple regulators going after the same firm for the same activities. It is duplicative. It is piling on. It is confusing. But there is a second, at least as important reason, and, that is, you don't

want regulation that is designed for one type of financial institution inappropriately placed on another type of financial institution.

Now, let me illustrate. Our securities markets and mutual fund markets are based on transparency, strict market discipline, creativity, entrepreneurial activity and risk taking. The SEC has repeatedly testified before this committee and other committees of the Congress that imposing banking regulation—which is premised on safety and soundness—would be a very serious mistake.

If you impose safety and soundness standards on entrepreneurial firms like mutual fund companies and securities firms, you could threaten the continued operation of the existing securities regulatory system and, as Chairman Levitt testified, even the health of our Nation's capital markets.

H.R. 10 generally recognizes this issue, and it has a carefully crafted mechanism to ensure that functional regulation is not undermined and that the kind of problems I just tried to outline don't develop. For example, H.R. 10 gives the Federal Reserve Board general oversight responsibility over the new financial holding companies. It also carefully prescribes and limits the Board's authority over non-bank regulated subsidiaries, such as mutual fund companies, to only situations where the Board believes it is necessary to prevent a material risk to the safety and soundness of an affiliated bank in the holding company, or to the payment system generally.

So you have kept the Board as a strong umbrella regulator, but you have set up standards to avoid a violation of functional regulation. And the bill, I am happy to say, does the same thing to the second banking agency, the FDIC.

Now, these standards for the Board and the FDIC were developed late in the prior Congress, and we think there probably wasn't enough time to create similar provisions to deal with the Comptroller of the Currency and the Office of Thrift Supervision. But given the overall intent of functional regulation and the problem of its violation, which Chairman Levitt indicated and I tried to indicate, the bill does have a loophole in this area.

We think Congress should now take the opportunity to close those loopholes and apply in H.R. 10 the principle of functional regulation, which you have already applied to the Fed and the FDIC, to the Comptroller and the OTS. Otherwise, if you don't, these two banking agencies easily could inappropriately apply bank-type regulation to non-bank entities. This would make absolutely no sense.

Also, there is no reason the OCC and OTS should have broader authority than that which you assign to the Federal Reserve Board, which is the overall umbrella regulator, or to the FDIC, who is responsible for safeguarding the deposit insurance fund. It is somewhat of a technical point, but I think it is important as you carry out the spirit of your bill.

The second two comments we have are ones that have already been raised, so they won't be as novel, but they may be as important. First, we do think, and this has been a controversial issue here today, we do think there ought to be a limited degree of non-financial activities allowed for the new financial holding companies. If you look at the industry I represent—the mutual fund industry—and other financial industries, they have never been barred from having commercial affiliates, and many of them have commercial

affiliates. We don't think they ought to be forced to totally divest themselves of those affiliates if they become subject to the new structure. We think to a limited degree, a commercial basket or something else ought to be done to accommodate commercial affiliates.

Third, we support changing the grandfather date for unitary thrift holding companies from October 7, 1998 to the effective date of this legislation. Institutions that have become or that have applications to become unitary thrift holding companies after October 7th have acted in full compliance with existing law, and should not be denied an equal opportunity just because of the accident of the date a bill was introduced.

In short, I appreciate this opportunity to present our views. We have been testifying on this issue for at least 21 years now. We are glad to see the progress, and we really hope that Congress in this session can move toward enactment. Thank you.

[The prepared statement of Matthew P. Fink can be found on page 379 in the appendix.]

Chairman LEACH. Thank you, Mr. Fink.

Mr. Smith.

STATEMENT OF MICHAEL P. SMITH, PRESIDENT, NEW YORK BANKERS ASSOCIATION

Mr. SMITH. Good afternoon, Mr. Chairman and Members of the committee. I am Michael P. Smith, President of the New York Bankers Association. From Main Street to Wall Street our association prides itself on diversity and our ability to achieve consensus within this diversity. We are also an organization which, while independent, also prides itself on working closely with our national trade groups and others in the financial services industry to achieve consensus beyond our State's borders.

Such a consensus existed at the end of the last session of Congress and is embodied in the provisions of the bill now before you. Today we are here to affirm that that consensus continues among our membership and hopefully among the financial services industry at large. The time is now to enact financial reform legislation which will provide an appropriate framework for financial competition in the 21st Century.

Fortunately, unlike the NFL, you get to reset the clock and hopefully place the ball back on the one yard line. Our association has supported financial reform for more than a decade. To achieve reform, we chose a policy of open markets for all financial service firms to play on the now famous, but still pristine, level playing field. The history of the last dozen years, characterized by globalization, new technology, and unprecedented innovation, has, as the committee knows well, only intensified the need for action. A steady pace of de facto reform has emerged from the courts, the regulatory agencies and the States. This situation has not disserved banking. In fact, many banks would opt for the status quo if rollbacks were to be the price of Federal legislation.

But this situation will not help us move to a new financial system in the 21st Century. Mr. Chairman, we know that you and your committee desire reform. You have been tenacious, and we would not have this historic opportunity if it were not for your

leadership. Your hearings will again lay the foundation for reform. In fact, it would be repetitive to retrace old ground. So I will focus today on the process that brought key changes to H.R. 10 in the insurance area. I will then describe for you the substance of these amendments.

There is no secret that only a handful of banking firms were supporting the final product which emerged from the House last spring. It is also no secret that banks were fairly isolated in this opposition. The insurance provisions were by far the most vexing to banks of all sizes. These provisions were not reform, they were retrenchment. That certainly was the belief in New York and we made this view known on the Hill.

As a consequence, reports were circulating in Washington that the banking and insurance war was alive again. That was the opposite of our experience back home in New York, where in 1997 we joined in a historic detente with our insurance agency groups and strengthened our close ties with the securities and insurance company organizations, the bedrock industries for the future growth of New York and the entire Northeast.

From our perspective the bank insurance issues have always been a war on two fronts, State and Federal. At the Federal level the unanimous Supreme Court decisions in *VALIC* and *Barnett* in 1995 and 1996 established the fact that under Federal law, national banks can sell annuities and have town-of-5,000 insurance agencies that can sell all types of insurance under rules specified by the OCC. The aftermath of *Barnett* was a firestorm of activity in many States, including New York.

At the State level in New York, we chose to respond to *Barnett* by reaching detente with the insurance industry. The guiding principle was functional regulation, where New York banks agreed that insurance activity should be subject to the State insurance department and to certain additional safeguards. In a bipartisan manner, we protected State banks through passage of a wild card statute whose purpose was to ensure that State banks may exercise the same rights and powers and engage in the same activities as their national counterparts.

In the last Congress, H.R. 10 as adopted by this committee was subsequently revised in the House, which on the whole took a significant step backward for the banking industry. In fact, it had the potential to unravel what had been accomplished in New York and other States. Rather than just oppose the bill, our board authorized us to seek improvements and to be engaged, and the most complex and contentious issue was insurance.

When H.R. 10 reached the Senate last summer, the leadership of the Senate Banking Committee on a bipartisan basis specifically turned to us initially to host and then to facilitate negotiations aimed at breaking the logjam on the insurance language, among agents, companies and insurance commissioners and the banking industry.

These negotiations went on from July to early October. As you know, the differences among the industry groups go back many years. Who on this panel could forget the votes on FDICIA? While the task was arduous, everyone around the table was professional, amicable and respectful, and in the end, the product was very good.

Through the process of give and take, we fashioned a document that was probably longer and more complex than many of us would have liked, but that achieved a final balance.

Many groups not immediately at the table were kept in close touch. I served as Chairman of the State association division of the American Bankers Association, which provided the valuable linkage and partnership with banking's grass roots. Ultimately, all elements of the insurance and banking industries came to embrace the agreement—for the first time in a very long history. As a result also 49 State bankers associations moved from opposition of the bill last spring to 49 in support last fall.

Before turning to the elements of this agreement, several points should be noted, and this comes up often in our discussions. Our mandate was to work within the framework of the House-passed bill. We were not starting from whole cloth. For example, even though banks in a number of States for years have been butting their heads against subtle, but effective State law that kept them out of the insurance business, we were not at liberty to seek a blanket preemption of State laws that have a discriminatory effect.

Rather our task was to find a flexible, workable framework for both banks and insurance interests without affecting the consumer safeguards worked out in the House. In the end, we did reach an agreement that allowed each of the participating trade groups to sign off.

In summary, the agreement included the following particular elements. First, effective preemption of anti-affiliation laws. The agreement contains a healthy new standard prohibiting a State from preventing or restricting any affiliation authorized by the bill.

Second, effective antidiscrimination language in connection with nonsales activities, by subsidiaries and affiliates. The anti-discrimination section goes to the heart of the bill. Insurance companies that are affiliated with banks must be treated the same as those that are not. In general, States are precluded from preventing or restricting banks and their affiliates from engaging in any activity authorized under the bill, unless a regulation is one of general applicability and does not discriminate against banks on its face.

Third, a carefully balanced set of insurance sales provisions, including a number of elements, and I would say that this is a compromise. Preservation of *Barnett*: The holding of the Supreme Court in the *Barnett* case is expressly preserved and a general standard is adopted that a State may not prevent or significantly interfere with the sale of insurance.

For new law, new strong antidiscrimination language: for laws adapted after September 2, 1998, the same antidiscrimination standards applicable to nonsales activities would apply. In court cases under this provision, determinations of the OCC and State insurance regulators will be considered without unequal deference, a compromise.

For old law, preserving deference in court cases: the OCC would receive deference in any cases addressing laws adopted prior to September 2nd, 1998.

A modification of the safe harbor for State insurance sales regulation: there was widespread belief that the safe harbor, designed as a specific carve-out for State regulation, was too extensive and

could act as an incentive for further State laws adverse to banking. New York was one of the States that had specifically negotiated a set of acceptable standards and felt that the provisions of the House bill were too extreme.

The safe harbor now in H.R. 10 avoids those extremes while responding to concerns of the insurance regulators, the agents and certain consumer groups regarding new competition from banks. The safe harbor now represents a consensus view of all the interested groups. Could banking have lived without a safe harbor? Absolutely. Could it have been dropped from the bill? Absolutely not.

Fourth, deletion of the requirement that banks must acquire existing agencies. It was recognized at the start that this provision should be dropped; also modifications were made to the title insurance provisions.

As you consider these provisions, we pledge to work with you with respect to any questions, ideas or new proposals that may come before you. We know that this is not a static process. At the same time, we would reiterate that the insurance package of H.R. 10 is finely balanced. We earnestly hope that any suggested changes be carefully considered in full consultation with all the parties.

Like the insurance amendments, there were other significant changes to H.R. 10, which we urge be retained, including the closing of the unitary thrift loophole, and the securities provisions. It is recognized that H.R. 10 is not perfect. There will not be perfection in such a complex document, but it is balanced.

It is the amalgam of a thousand hours of work by a thousand hands. We were just one of those and, as such, we urge that you proceed in finishing the work which you have so ably fostered. We thank you for the opportunity today.

[The prepared statement of Michael P. Smith can be found on page 393 in the appendix.]

Chairman LEACH. Well, thank you very much, Mr. Smith. And thank the panel, and I want to commend in particular the choice of America's Community Bankers in having Ms. Beard speak. You have given testimony that, in one hand, appears common sense, on the other it defies a little bit of history. And I want to go back just a little bit if I could just to review.

We have to view our legislation as a continuum. That is, it doesn't start with day one. And if you go back on what the S&L industry has been given, we transferred $6 to $8 billion of your industry's liability to Mr. McQuillan's and to Mr. Jones' institutions. That is an extraordinary transfer of obligations. The quid pro quo that was understood by everybody was that we would have equality of regulations, not a privileged circumstance in the market. And what your testimony is doing in effect is saying you want to be in a privileged position, vis-a-vis Mr. McQuillan's institutions and Mr. Jones' institutions.

We have in the last several years enhanced the thrift charter. We have liberalized the QTL test. We eliminated a multibillion dollar tax liability related to thrift bad debt reserves. We in the United States Congress committed $140 billion of taxpayer funds to underpin the S&L industry; in current dollar terms, 2½ times that if you take interest into consideration. And we have done that

knowing the number is going up now, because of certain legal liabilities that exist in the industry.

And the reason I raise this is, I mean I want to go directly, because I feel your industry has been presenting one-sided perspectives to its membership. It objects—in your testimony, you object strenuously, for example, that this legislation—and let me find your words here, imposes an additional burdensome notice and comment process.

Well, that burdensome notice and comment process is called government in the sunshine. It is also precisely what is required of the Office of the Comptroller of the Currency. And so I think it fair to ask you, Ms. Beard, why you object to government in the sunshine and why you believe you should operate under a process and procedures less onerous than Mr. McQuillan and Mr. Jones? I mean if the OCC has a requirement, why shouldn't the OTS? This is very significant.

Finally, let me just conclude by noting, many might have thought the ACB came out of this legislation rather extraordinarily well. Every community banker I know not only wants to preclude further unitary charters, it wants to cut out those that have been offered, because the theory of the charter was, as put forth in this Congress, to allow more purchasers of failed thrift assets.

And now it has become something very different. Instead what this bill does is that we leave the thrift charter—the unitary charter intact. We grandfather existing unitaries and we repeal the SAIF special reserve, something your industry wants. I think that is an extraordinarily fair compromise. And given a continuum and a history, I would think of all the institutions before this panel the one that would be the most appreciative of this bill and the most appreciative of the United States Congress would be America's Community Bankers. And instead we have the exact opposite representation.

And I throw this out, because it is my view that you have not given a historical representation to your entire membership that is reflective of what I think are extraordinary compromises in this bill and an extraordinarily helpful history of this Congress vis-a-vis your industry.

I would like you to have a chance to respond to that.

Ms. BEARD. Certainly. There were several points in there, and hopefully I will remember all of them. But one of them is to make sure it is understood that America's Community Bankers clearly appreciates the Congress and all that it does. And the process that we have in our congressional dealings is that there are opportunities such as this to bring forth issues and to put those issues forward in a very honest way.

And we think that ACB, among all the industries represented here, is very principled in that we stand for the same thing consistently. At the end of the debate on H.R. 10 issues last year, we had dealt with some compromises that were important and appropriate at the time. We think that now there is a new Congress, and we appreciate that new Congress and their new Members of the Congress, so we think now it is a chance to look again with fresh eyes at things.

In terms of preferences, you referred to community banks. We consider ourself a community bank. The members of our community call us a community bank. So I think the issue is not the savings and loan industry, the thrift industry, the banking industry; I think it is the financial services industry. A number of years ago, I won't remember the exact dates, what was then—what were then separate industries, the banking industry had a number of difficulties, larger banks were lending outside the country, resources had to be allocated to save that. Banks in Oklahoma were having problems. Resources had to be allocated to that. We are no longer separate industries. So I would argue this is about the industry trying to help itself, not savings and loans or banks trying to help each other.

Chairman LEACH. I appreciate that. And I will only conclude because my time has expired. The commercial banking side never required a tax bill payout. Second, what I am hearing from commercial bankers, and I mean around the country, is that if you are going to grant someone an unequal charter, which is the current landscape, then we object strenuously to taking on their liabilities in the deposit insurance fund.

And if they are going to have an unequal charter they ought to pay an unequal part of the insurance fund. And would you like us to go back and change vis-a-vis the insurance fund what we passed in the prior Congress that caused Mr. McQuillan and Mr. Jones' institutions to pick up your institutions' deposit insurance liabilities? Would that be a fair quid pro quo, or would that be an unfair one?

Ms. BEARD. Well, I think the fair thing to do would be to offer different charter choices throughout the industry. And this is not about one part of the industry having preference any more. It is really about options and choices, diversity and flexibility. And so I would suggest that we expand the powers to other kinds of institutions, too, and not make it preference just for what used to be called a savings and loan or a thrift.

And if I could just make another point about the sunshine issue, what we are dealing with there is really notice and comment on specific actions. What we would suggest as an alternative would be that perhaps notice and comment could be given for standards under which the OTS or whoever might deal with.

Chairman LEACH. But would you want to maintain a privileged position versus the OCC, I mean is that your position? What I am saying is that we are trying to do common sense things and equalize regulation and not have anybody left with a privileged status. As it is, this bill grandfathers, which does keep a given amount of privilege, and the quid pro quo that Mr. Jones and Mr. McQuillan asked for is at a minimum that there be no more.

And so we have really—what I am saying is we have gone an immense, long way for you against the views of the vast majority of bankers in America, and I just want that message given to your membership.

Ms. BEARD. We will certainly pass the message on.

Chairman LEACH. Thank you.

Mr. LaFalce.

Mr. LAFALCE. I regret that I couldn't be here for the presentation of the panelists. And I regret that you had to respond, Ms. Beard,

to these difficult, challenging questions but you did an excellent, excellent job.

Ms. BEARD. I appreciate the opportunity to be here and respond.

Mr. LAFALCE. Good, both substantively and otherwise. Let me—because of the fact that I wasn't here for the presentation—defer to the other Members and then reserve the balance of my time for the time when the others have concluded.

Thank you, Mr. Chairman.

Chairman LEACH. Mr. Baker.

Mr. BAKER. Thank you, Mr. Chairman. I would feel some necessity as a Representative of one of the contributing States to the 1980 difficulties merely point out that anyone alive in 1980 and alive today was probably not a contributor to the ill-advised investment practices that lead to the closure of many institutions in our country.

And, second, that the RTC, given the responsibility for disposal of assets secured as a result of those failures, in my judgment, did not only the industry, but taxpayers a disservice by selling those properties at bargain basement prices, when history shows that many who invested in those assets, whether they be real property or notes of securities, profited great margin at taxpayer expense.

Had we managed our way out of that debacle, we perhaps could have limited losses to the taxpayer by considerable measure. Having said that, I certainly understand the concerns of those who see inequities in the marketplace and they should certainly be addressed.

To that end, Mr. McQuillan, let me ask this question, as I understand the law today, a company, Subchapter S corporation may not in your hometown own the bank or the automobile dealership or the grocery store. But as is the case at least in my State, particularly in small towns, board members, owners of the hometown bank, all too often are the owners of the automobile dealership and the grocery store.

Is it inappropriate, in your view, given the dangers the complexity of merger of commerce and finance for individuals who may own a small town bank, should we close that dangerous loophole and say that individuals should not be allowed to own the grocery store and the bank? And if not, why is that different in operation from a Subchapter S corporation where three board members join together and decide to buy the bank and the grocery store?

Mr. MCQUILLAN. Well, the real issue here I think is the risk to the system, the financial services industry and, in the end, the FDIC fund. I can't imagine that me owning a grocery store in Greeley, Nebraska in any fashion would be a risk to the total financial system of this country or the FDIC funds.

So I do think, even though the concept is obviously the same, it is a lot different than a unitary thrift holding company. The thing that concerns me is the risks to our system of these unitary thrifts if they are allowed to proliferate exponentially how much risk it creates for the FDIC fund.

Mr. BAKER. If you were given assurances that in your judgment would be enforceable, where the supposed risk from alternative business investment would not have access nor protection from in-

sured depository funds, would that eliminate your concern about commerce and finance?

Mr. McQUILLAN. I cannot imagine that happening and I would not support that, no. I just can't imagine that happening.

Mr. BAKER. So on the one hand it is OK for the company to do it, but not for the individual, even though we know the issue of risk. I don't want to press the issue. It is just important to me to establish that individuals do engage in this enterprise to no great untoward risk to the American citizen, nor is it the case where the unitary thrifts which I understand the concern of your organization—has there been, do you have information that the operation of unitary thrifts over the past decades has led to any higher or more significant risks to the taxpayers or contributed more significantly to taxpayer losses than a typical bank?

Mr. McQUILLAN. I don't have any knowledge of that, no, sir, I don't.

Mr. BAKER. My information is that the losses among unitaries is fairly consistent with that of any other marketplace participant. And it is difficult to understand, particularly in rural America, where you have someone with resources who simply wants to bring in more product and services to consumers, why the government would say that is a bad thing to do when there is not a history or higher degree of loss among that diversified business interest.

And that really is my point. We want to help consumers in small communities get access to services that a highly regulated commercial bank may not always be able to provide under the current regulatory system. And those of us who feel that the unitary charter or diversified commercial and banking interest is appropriate are doing so on the basis that it is best for the consumer, not worse.

Thank you, Mr. Chairman.

Chairman LEACH. Thank you very much, Mr. Baker.

Mr. Vento.

Mr. VENTO. Thanks, Mr. Chairman. I was reminded as you went through that sort of painful history of the last years and addressed the question to Ms. Beard of the efforts to try to harmonize all of these laws at the Federal level, and we haven't even talked about the State. But this bill doesn't address most of what happens at the State level in terms of the powers granted to financial institutions.

So invariably, whether it is commerce or operating subsidiaries, we have to rely on the Federal Deposit Insurance Corporation or something to address those functions. And it is just that particular entity all by itself that does that. And I dare say that probably some members of all of your organizations that operate don't differentiate between the charters that have such powers.

And I don't expect that you are suggesting that we ought to try and solve them in one fell swoop, but the FDIC does address them in that sense. Obviously, the thrifts put a lot of money themselves into the thrift safe resolution, and as Mr. Baker said, the survivors are hardly those that probably warrant the type of challenge that we might still feel.

I mean I can certainly sympathize with what our Chairman is saying in that regard and having been through this process. But let me turn to Mr. Jones. I appreciate, I just want to note, Mr. Chairman, that about seven of the first ten witnesses here have

testified in favor of an operating subsidiary to be addressed here. And in terms of commerce banking, albeit not in the semantics of a basket perhaps, but some have directly addressed that, but in the complementary to financial and/or commercial—or the other verbiage that is in the current bill, H.R. 10.

But let me turn to Mr. Jones and say, you know, maintaining two holding companies' structures is what you testified to in an operating subsidiary or a holding company affiliate. Why is it important to maintain a choice for banks? Why does the ABA favor that particular position in terms of a choice?

Mr. JONES. Congressman Vento, I think you know our history on this issue. We support any system that offers the greatest flexibility for the providing of products and services to our customers, whether it be in Red Wing, Minnesota or in New York City. We have been supporters of the operating subsidiary approach over the last few years, because we believe it offers the most flexibility and, therefore, ultimately the most benefit to the client or to the customer.

So we have been on the side of operating subsidiaries. But this morning, John McCoy testified to the issue of choice. And in each community across this Nation, there will be different banks making different business decisions based on where best to place a particular financial opportunity. Should it be in an operating subsidiary, should it be in an affiliate of the holding company? And I think that is why the issue of choice, freedom of choice, is where we stand today.

Mr. VENTO. One of the observations is that generally larger financial institutions may favor a holding company type of structure. Is there a factor here that deals with size, Mr. Jones, that makes an operating subsidiary more attractive than a holding company type of structure?

Mr. JONES. Well certainly, Congressman Vento, in our particular case, and let me take you to our small holding company. We are only about $800 million in total assets. In our case, it would be very cumbersome and very difficult to set up separate operating affiliates in the holding company using what is envisioned. I think we are much more comfortable, with the op sub because there is less cumbersome regulation in the way and structure in the way of delivering this service.

But I also am fortunate enough in my role as president of the ABA to talk to many big banks. And it is not necessarily true across the board that large banks only support the holding company structure. In many cases, they would much prefer operating subsidiary approaches as well.

Mr. VENTO. Because in a branch or another entity they then can reach out? I mean it keeps a viable financial services resource in a geographic location under those circumstances closer to the people that are intended to be served?

Mr. JONES. Yes.

Mr. VENTO. Mr. Smith, I was reminded as you went through your testimony of all the flaws with regards to insurance. Those have been rectified, you know, you sort of went through a litany and pointed out that the bill had passed the House, it wasn't really

a step forward in terms of financial modernization for banks but a step backward. Am I paraphrasing you correctly, Mr. Smith?

Mr. SMITH. That's correct, especially in terms of the insurance provisions. I know a lot of the discussion on the other points——

Mr. VENTO. Well, it did repeal Glass-Steagall.

Mr. SMITH. In terms of one of the questions that come up often, what does this bill mean for community banking? And the insurance provisions apply to all the banks, for example, in the State of New York, State or national, whatever their size. And for our State and for many other States, the provisions which were constructed in many cases beyond the purview of this committee, for us, took a step backward.

For example, the safe harbor provisions were a problem for many of our banks. We were concerned about the provisions dealing with having to buy existing agencies, the provisions dealing with title insurance, and these are generic issues across the whole sphere of banking. And when States like New York, which, following *Barnett*, as I noted, passed a wild card statute—I believe over 40 States have wild card statutes—were just beginning to benefit from changes in law to sell insurance, we thought the last thing we should have in a reform package were more restrictions or more restrictive law.

However, at the same time, we were realists. We knew that this was a very contentious item and that it was going to take some time. So we were seeing where the industry was affected. And I think it turned out to be a balance and everyone is on board. But coming out of the House certainly the insurance provisions, with a handful of banks supporting, was one of the main issues with which we were concerned. Obviously, it is a big bill, and the items that we focused in on were the insurance items.

Mr. VENTO. I am looking at the issue that affects medium-sized or smaller banks and insurance and op subs are two of them, I believe.

Thanks, Mr. Chairman.

Chairman LEACH. Thank you, Mr. Vento.

Mrs. Kelly.

Mrs. KELLY. Thank you, Mr. Chairman.

First, just out of curiosity, I would kind of like to ask a question that sort of establishes something in my mind. I would like to ask you all just for a simple yes or no. Would any of your groups oppose H.R. 10 if it stayed as it was without a commercial basket also known as a two-way street? Let's just start with you, Mr. Jones.

Mr. JONES. No, we would not oppose; we support it.

Mrs. KELLY. Mr. McQuillan.

Mr. MCQUILLAN. I'm sorry, can you repeat the question? If the bill would stay the same?

Mrs. KELLY. If H.R. 10 stayed as it is without a commercial basket, also known as a two-way street, would any of your groups oppose it?

Mr. MCQUILLAN. No, I don't believe—I mean what has——

Mrs. KELLY. Just yes or no. Would you oppose H.R. 10 as it stands now without a commercial basket or that two-way street?

Mr. MCQUILLAN. No. No, ma'am.

Mrs. KELLY. So, Mr. Jones, you said no. And, Mr. McQuillan, you said no.

Ms. Beard.

Ms. BEARD. It is not a question that I could answer. This process is important——

Mrs. KELLY. No, ma'am. I am asking for a yes or no answer here.

Ms. BEARD. I wouldn't know what we would answer on that. We haven't evaluated it that way.

Mrs. KELLY. So your group of bankers would not be able to give an answer? How can they have you testifying if you haven't evaluated what this bill actually means?

Ms. BEARD. We do not agree with provisions of the bill as it stands now, but we also understand that there is an opportunity for discussion for possible change, which is why we are here today.

Mrs. KELLY. I asked you a simple question about what it was, and pieces of it that might not be there, even if we do have a discussion about it.

Ms. BEARD. There are pieces in the current bill that we would not agree with.

Mrs. KELLY. OK. If the bill just stayed as it is, then you would not be in favor of—you would not be able to back H.R. 10; is that correct?

Ms. BEARD. That would presume there is no opportunity for compromise, and we believe there is.

Mrs. KELLY. That is my presumption in this question.

Ms. BEARD. So your presumption is we are at the end of Congress and there is no opportunities?

Mrs. KELLY. No, I'm just finding out, this is my own interest.

Ms. BEARD. That is fine. I wouldn't be able to answer it.

Mrs. KELLY. Thanks. I think maybe you did.

Mr. Fink.

Mr. FINK. We would not oppose.

Mrs. KELLY. You would not oppose it.

Mr. SMITH. We support H.R. 10 as it stands.

Mrs. KELLY. You support it. Thank you very much, Mr. Smith.

Actually, Mr. Smith, I am interested in the New York bank's agreeing that insurance activities should be subject to the State insurance department. I find that was something that was very significant in order—in my mind, it had to be very significant to you all, to get some State recognition and some kind of a balanced approach to the insurance and banking provisions in New York State. But you also talked in your testimony about the wild card status that gives State banks parity with national banks, and that is of interest to me also.

Can you explain what a wild card statute is, and why it is called the wild card statute?

Mr. SMITH. Well, I can't go back to the history, except that I believe it started out in the West or the Southwest originally so that State banks could keep pace with Federal changes. And as you well know, Congresswoman, New York has a tendency to want to keep and to regulate its own and to set a high standard for its financial services industry. So New York had previously never passed a wild card statute. Wild card, I guess if you take it as a deuces wild, ba-

sically allows the State to mirror Federal action at any time that it wishes.

And in the case of New York, like other States, that would mean that the banking department or banking board would have the authority to mirror change without any legislative change, legislative change taking upward of two to three years, if not longer, to get passed. In which case, in the State of New York for example, we estimated that we would lose many State-chartered banks (as did the State of New York), because of changes due to the Supreme Court cases in *Barnett* and others.

So, therefore, wild card became very important. It required a State law change to get it, and it has worked extremely well in New York. For example, now banks in New York under this wild card statute can sell any form or most forms of insurance. Most recently, property and casualty insurance was approved through a Federal court case and then banking board action in the last year-and-a-half.

Also at the same time, you ask about functional regulation. That was a big issue, a major issue. Actually, New York faced that in the early 1980's. New York had a commission that was set up by Governor Cuomo that comprised all the elements of the financial services industry, including consumer groups and members of the legislature.

It came out with many of the provisions that are now in H.R. 10, some 15 years later. It started because insurance companies in New York had a proviso in a bill in Albany to be able to own a bank, and because of that, we had a year-long commission that recommended many of the things that are in H.R. 10 today. One of them was if you want to get into banking, you go under the banking department—by the way, everybody talks about banks being concerned about functional regulation, but it is a two-way street.

The insurance industry is concerned about getting under the banking department. And quite frankly, many States now are merging their departments. And quite frankly, we believe strongly that if we are going to sell insurance, that it is only appropriate that we be licensed and regulated by the insurance department. And we have accepted that and a lot of people take it for granted, but that was not an easy—that was not easy for our industry, nor was it easy for the insurance industry.

Mrs. KELLY. Thank you very much, Mr. Chairman.

Chairman LEACH. Thank you, Ms. Kelly.

Mr. Watt.

Mr. WATT. Thank you, Mr. Chairman. I wanted to just get a clarification from Mr. McQuillan. You were going through a list of six or seven points that you either supported in this bill or I think in one or two cases you maybe had some concerns about. And during that discussion, I thought I heard you say that you felt strongly that the Fed ought to be the oversight body as opposed to the OCC. Did I understand that correctly or did I misunderstood that?

Mr. MCQUILLAN. On a financial service holding company, Congressman, yes, on riskier activities, yes, they should be the oversight body for the financial service holding company.

Mr. WATT. OK. But not on the banking part of it, I take it?

Mr. MCQUILLAN. The umbrella regulator.

Mr. WATT. The holding company, the OCC would continue to have oversight on the banking part of the operation or who would have oversight?

Mr. MCQUILLAN. Well, the bank—it depends on what the bank does. But if it is deemed to be a financial service holding company and they have other functions that they are involved in that are risky, for instance, insurance underwriting, those types of things, they ought to be pushed out into the holding company and the Fed should be the umbrella regulator for that entity.

Mr. WATT. OK. Maybe I should just talk to you separately about that. Let me go to a follow up on what Ms. Kelly was asking. Add to H.R. 10, the Chairman's mark, the possibility of an operating subsidiary. Mr. Jones, does it change your opinion about whether you support the bill or don't support it?

Mr. JONES. No, Congressman, we would still support the bill.

Mr. WATT. Mr. McQuillan.

Mr. MCQUILLAN. It would be a concern of ours depending——

Mr. WATT. Support it or not support it?

Mr. MCQUILLAN. What are you talking about, being in the op sub? I guess the riskier activities I would oppose. Is that what you are saying?

Mr. WATT. Well——

Mr. MCQUILLAN. It would have to be, that is all it is saying. So I would have to oppose.

Mr. WATT. OK. Ms. Beard didn't have an opinion on the last one so I guess she is not going to have——

Ms. BEARD. As to simply the operating subs, we would believe the operating subs would be——

Mr. WATT. I am talking about the whole bill. So if you don't have an opinion on the last one, than I take it you don't have one on this one.

Mr. Fink.

Mr. FINK. It would not change our support.

Mr. WATT. Mr. Smith.

Mr. SMITH. We would support.

Mr. WATT. Add some modest basket not to exceed 15 percent. Mr. Jones, do you support the bill or do you oppose it?

Mr. JONES. We would continue to support the bill, but we believe 15 percent may be a bit high.

Mr. WATT. OK.

Mr. McQuillan.

Mr. MCQUILLAN. We would oppose.

Mr. WATT. Mr. Fink.

Mr. FINK. We would support much more enthusiastically.

Mr. WATT. Mr. Smith.

Mr. SMITH. Our association is neutral on the basket.

Mr. WATT. So if you were supporting the bill before then you would support it this time?

Mr. SMITH. I would say we are neutral on the issue.

Mr. WATT. OK. All right. I was just trying to figure out where the players are. Just as a matter, since I've got a half a minute left, Mr. McQuillan, why does that last wrinkle—just explain to me quickly while the last wrinkle scares you off of supporting the bill.

Mr. McQuillan. Banking and commerce is just a line that we do not ever want to cross, anything over zero percent.

Mr. Watt. But what if you put it up in the—you went back to the holding company concept, no op sub, you put it up in the holding company, then what is your opinion on it?

Mr. McQuillan. Banking and commerce is just a line.

Mr. Watt. So it would still scare you away, OK.

Mr. McQuillan. Too much risk to our financial system.

Mr. Watt. All right. Thank you, Mr. Chairman. I yield back.

Chairman Leach. Thank you. I think next is our distinguished gentleman from the far West.

Mr. Hill. Thank you, Mr. Chairman.

Mr. Smith, first let me begin by complimenting you on what you did achieve with regard to the negotiations with regard to insurance. Then let me ask you some questions about what I see as problems in part of that agreement.

The current language in H.R. 10 does not have the support of State insurance regulators; is that right?

Mr. Smith. That's right.

Mr. Hill. And the reason for that is because they believe it preempts authority they think appropriately belongs to them, would you agree with that?

Mr. Smith. That's correct.

Mr. Hill. And it isn't so much the affiliation issue as it is regulating sales and regulating matters regarding solvency that concerns that. Would you agree with them?

Mr. Smith. I would defer to them. I don't know whether they are testifying, but I don't want to speak for them. But they were in our discussions early-on and made their views very clear, and I think those views were articulated before this committee during its markup or hearings last year.

It was a fundamental issue that I can tell you right now concerned the banks and the insurance companies. It was also the direction the U.S. House of Representatives and the Congress were moving forward to. We can't just cede authority to a State to intervene on affiliations. For example, there was a whole debate on this. It is a fundamental issue.

It was clear that we were not going to be able to as a group agree on their position. So the decision was that there were modifications made in the Senate bill regarding disclosures that they could request on affiliations, imposing capital requirements, on subsidiaries operating in a State, and that was as far as we could go. So you are correct, and it was felt to be as good as we could get.

Mr. Hill. I mean we don't really have functional regulation in terms of the traditional history with regard to insurance regulation.

Let me go on. I admire your work because I found that dealing with this issue kind of like Middle East politics, there are three positions. There is the public position, the official position and the real position. So sometimes it is hard to figure out just really what you can and can't do.

One of the other concerns that I have frankly is what you referred to as a noncompetitive title insurance provision. Since I was the author of the provision that went into H.R. 10, I particularly

take issue with that description. And, frankly, because really H.R. 10 as it now stands would substantially leave title insurance, in my view, unregulated, at least so far as consumer protection is concerned, and basically would leave it I guess to the OCC to write regulations of title insurance sales since it is your view that should occur within the bank or within a subsidiary of a bank; is that correct?

Mr. SMITH. Well, can I just go back one minute to this question of functional regulation? There is no Federal regulator of insurance, to my knowledge. De facto, the insurance regulators of each of the 50 States are the regulators. It is understood. Now I know that has been an issue. And I know it is debatable and you can debate that in academic terms, and quite frankly I heard a lot of that debate. But the facts are that in the State of New York at least the insurance commissioner is the regulator of selling insurance. And I would believe, but I don't want to misspeak, that the insurance commissioner would maintain that authority in the sale of title insurance, as it is my understanding that a State bank in New York can do that today.

Mr. HILL. If we were to debate that we would say so long as it doesn't interfere with the powers of a bank, the national bank?

Mr. SMITH. Only interfere to the extent of discriminating to the extent that the bank in effect could not participate in that product.

Mr. HILL. Let's go, for example, to the Ohio situation, which right now is being litigated, where the State of Ohio requires that title insurance companies generate 50 percent of their revenues from someone other than their affiliates. That is being challenged, as I understand it, under the principles of the *Barnett* decision that there is a significant interference.

Mr. SMITH. Correct.

Mr. HILL. Under H.R. 10 as it now stands, deference would still go to the OCC if the OCC determined that there was significant interference, correct?

Mr. SMITH. On current law, correct.

Mr. HILL. Current law. So that leads the OCC to determine whether there is going to be any regulation or not any regulation in that event since the State would be preempted, right?

Mr. SMITH. You still would have litigation. But at the same time, from being in the talks, I can tell you from banking's perspective, obviously, banking's view did not prevail. Banking would have preferred that that law would be preempted, because it created in fact a discrimination and would have preferred to preempt State laws, as I mentioned. That was not in the cards. So you have this litigation process. And so basically you have current status on current laws as it relates to the Ohio statute.

Mr. HILL. The problem I see here, and my time is expired, is that with regard to other forms of insurance sales, H.R. 10 in essence preempts the State regulation by setting forth regulation. But it isn't going to do that in title insurance. And so I guess I would just conclude by saying that the concern that I have is that I think there are serious concerns for consumer protection with regard to title insurance being sold by the people who are the primary beneficiaries in the insurance.

Mr. SMITH. My understanding, Congressman, is——

Mr. HILL. And that is really left without any protection now in my view.

Mr. SMITH. My understanding, Congressman—we would get back to you on this, and to the panel—that banks are selling title insurance today, and I believe they would be regulated by the State insurance department. And the safeguards that are in the H.R. 10 today are the so-called safe harbors, which give to the State regulators very clear authority to act in those number of items. So there is relegation to the States, a very clear delineation on what the States can do, and it was explicitly a compromise. And by the way, the safe harbors emanated from the House.

[The information referred to can be found on page 401 in the appendix.]

Mr. HILL. One last point then, we are—are there any title insurance interests that support this provision of the bill? Were they part of these negotiations?

Mr. SMITH. No, they were—in fact, title insurance, I mentioned title insurance in my statement specifically as a matter that the banking industry was deeply concerned about. It was not from the insurance sector that is coming up afterwards, they did not have a position or did not—this was banking's view that the provisions coming out of the House were unacceptable, and the title insurance association—I don't want to speak for them, I believe they were opposed.

Mr. HILL. OK, thank you, Mr. Smith.

And thank you, Mr. Chairman.

Chairman LEACH. Thank you, Mr. Hill.

Mr. Bentsen.

Mr. BENTSEN. Thank you, Mr. Chairman, and I apologize for being late.

Mr. Jones, you said that you would support H.R. 10, is that the position of the ABA? And the reason I ask that is, you know, I may be wrong, but H.R. 10 I believe in dealing with the operating subsidiary uses the language that was in the last Senate compromise which, if I understand correctly, would set a billion dollar asset cap, is that correct, on the ability to have an operating subsidiary?

I yield to the Chairman.

Chairman LEACH. On the billion dollar cap that is one of the ideas that has circulated for a month or two, but it is not in this bill. This is the Senate language on——

Mr. BENTSEN. Which is open ended for investment banking purposes, securities purposes?

Chairman LEACH. I don't know if the term "open ended" is appropriate. But it is—but you can only do agency in the op sub.

Mr. BENTSEN. So it is restricted, more so——

Chairman LEACH. It is more restrictive than what passed the House Banking Committee last year.

Mr. BENTSEN. But what passed the House Banking Committee. But the ABA would support that?

Mr. JONES. That's correct, Congressman.

Chairman LEACH. Excuse me, I don't want to interrupt. I don't want to speak for Mr. Jones. I think Mr. Jones is referenced to supporting H.R. 10 as introduced this year.

Mr. JONES. That's correct.

Chairman LEACH. Rather than otherwise; is that right?

Mr. JONES. That is correct. That is what I am referring to.

Chairman LEACH. That is what you meant?

Mr. JONES. That is what I meant.

Mr. BENTSEN. Sorry, go ahead.

Mr. JONES. The Chairman is exactly right. We are in support of H.R. 10 as introduced this year before this committee. It is fair to say that in the last Congress we were in support of H.R. 10 as it was working its way through the Senate, but we are fully supportive of H.R. 10 as it appears before you today.

Mr. BENTSEN. Would the ABA's position be limited to that? Is the ABA no longer interested in the broader operating subsidiary?

Mr. JONES. As we have all been asked a series of yes or no questions——

Mr. BENTSEN. I will give you more latitude than that.

Mr. JONES. I appreciate that. But I feel sorry for Ms. Beard, who was put into that position. Let me tell you that the ABA still believes very strongly in a number of its closely held positions, one of which is that the freedom to choose, which Ms. Beard referred to in my testimony, should be there for operating subsidiaries. But we do not think that a bill should be stopped because of this issue. It is for us more important to see a bill move than to argue this point to the end of the earth.

Mr. BENTSEN. OK. Mr. McQuillan, the IBAA is opposed to the commercial basket concept. Would the IBAA support a more structured commercial program that—I mean, the Chairman talked today about incidental to finance; although that may not be broad enough. I mean would the IBAA support a financial modernization that gave a bank through, in my preference, an operating subsidiary, but even through an affiliate, the opportunity to engage in merchant banking activity, assuming it was safe and sound and separately capitalized, the ability to take positions for its own account and some latitude in the commerce side beyond what is in H.R. 10, but perhaps not as far as in Mr. LaFalce's bill?

Mr. MCQUILLAN. The way I understand your question is merchant banking insurance underwriting and those types of—what we deem riskier issues should be pushed out into the op sub; so if they are not there, then we would probably, if that is your question, we wouldn't support anything that wasn't pushed out.

Mr. BENTSEN. But you would support some commercially related ventures outside the bank either through a subsidiary or an affiliate within the holding company structure?

Mr. MCQUILLAN. No, not any more than has already been introduced.

Mr. BENTSEN. OK. If I could very quickly, Mr. Chairman.

Ms. Beard, has the ACB given thought to—and I am sympathetic to your position on the unitary thrift, but has the ACB given thought to some form of a grandfather provision that preserves current unitary charters that—and perhaps even some in application, I don't know, that is another can of worms, but preserves the power of the current unitary charters and allows for transfer in all cases, except to other commercial entities, or is there a particular problem with that type of transfer prohibition, sale prohibition?

Ms. BEARD. To answer your question specifically, we have given it thought, and there are a number of compromises that might end of up having to come forth by the time all of this is dealt with. But in terms of not being able to transfer our institution as an example, we have that transfer right now and our stockholders understand that transferability is there.

So to go back to them and say the rules changed after the fact, when there has been no demonstration of risk to the funds, for example, or to the industry would be difficult.

Mr. BENTSEN. And with the Chairman's deference, you would—I mean could you tell us if you can't sell your institution to another commercial entity, but can sell it to the market or sell it to another thrift or a bank, does it have a significant effect on the asset value of the institution, you believe, or the market value?

Ms. BEARD. I believe it has an effect, I don't know the significance. I couldn't quantify that for you because we haven't had to face that as an institution. But I believe it would have an effect.

Mr. BENTSEN. Yes, sir.

Mr. JONES. Congressman, if I could just add one more thing on that issue. Obviously, the ABA is coming from a different position on this. But I think Ms. Beard talks about limited choice to sell her institution to another commercial entity. In fact, there are some 10,500 potential purchasers of her organization that are amongst the thrift and banking communities. So we see very little, if any, problem in terms of choice to sell her institution or her members' institutions.

Mr. BENTSEN. Thank you.

Thank you, Mr. Chairman.

Chairman LEACH. Thank you.

Before turning to Mr. Ose, let me just mention, you mentioned the word incidental. Earlier in the hearing I threw out the combined term "incidental" and "complementary," too, which is a fractional broadening of a given precept.

Mr. Ose.

Mr. Sweeney.

Mr. SWEENEY. Yes, thank you, Mr. Chairman. I, as well, will apologize to the panel for having missed your testimony. But I did take the opportunity to read some of your testimonies and study the variety of the issues. And I found myself relying on those things that I knew a little bit about, and I will emphasize a little bit.

And, Mr. Smith, I appreciate the work both of your group and you personally in New York and in this venue in forging the agreements between banking and insurance industries. You have spoken a little bit about some of the preemptions that might occur with Federal law.

Could you characterize in those deliberations what you anticipate—outside of New York, because New York is less in contention at this point—could you characterize the level to which State laws would restrict the sales of insurance and which would be preempted in the current H.R. 10 language? I am interested in the volume and what you anticipate in terms of how difficult it would be to transition.

Mr. SMITH. Well, it is not a simple answer. The bill as it stands today does to a great extent protect State laws. There was no issue that from the first meeting there was going to be "preemption of State laws." However, there was going to be an exception in the affiliation area for companies, but in the sales area it was going to have to be a very delicate balance. It has already been referenced, the Ohio statute.

There are other statutes in the United States like that that are on the books today that clearly would elicit strong opposition from the other side, if they were preempted. So, therefore, that is why you see what you have today, which sounds difficult to explain, but which is a bifurcation between current law, those laws on the books, preserving what basically is in the law, and then a very strong statute going forward on nondiscrimination and leaving OCC deference out in prospective law.

Those are all very delicate balances and agreements that were made which quite frankly took a lot of time. And the safe harbor, too, is designed not to be preemptive in nature. There are banks and there are people who have criticized the safe harbor. And as I said in the testimony, we certainly could live without a safe harbor.

It is there for one reason, to preserve in certain very distinct areas, and they are not small areas, insurance regulation in the States. And they are there because quite frankly the industries involved wanted to have legislation.

And it was very clear that there was not going to be legislation if there was not some balancing and compromise. And it is just not to say this law is preemptive: this law is not, would not give justice; what it does is allow States to move forward like New York. And I am not saying New York just because I come from New York, but we have a pretty vibrant insurance industry in New York, and 50,000 insurance agents and 200,000 bankers.

And, quite frankly, we sat down and decided that as long as there were proper disclosures, licensing enacted by the insurance department for bank insurance salespeople, let's get on with it, and that was the decision. And Ohio statutes, as Mr. Hill has pointed out, Ohio statutes are going to be litigated under H.R. 10 as they are being done today, because we felt at these talks that we could not solve those issues and the delicate balance would be broken.

Mr. SWEENEY. Are there other jurisdictions that have made that kind of a determination that we could potentially face that kind of litigation? Is there that?

Mr. SMITH. Oh, yes. Yes. There are States in the United States where I am sure some Congressmen and Senators are hearing that, despite the agreement, that they feel that this is a preemption of their State's insurance laws. And at the same time, you always know you have a balance when you have got banking interests saying we don't agree with the safe harbor, we don't agree with this bill because you should have gone for preemption.

So, yes, there is going to be a discussion of this and I believe debate as you go along. What you had before you today was quite frankly the best we could do, and I hope that the insurance panel which follows would concur in that.

Mr. SWEENEY. As I try to put my arms around the issues, I would like to have some further discussions of where those controversies may come from. But as my time runs out, I have one other question for you. In your testimony you credit the New York bankers' support for modernization stemming from the 1984 commission recommendations. Could you very briefly give me a thumbnail sketch of those recommendations?

Mr. SMITH. I mentioned earlier that the insurance industry supported a bill in the early 1980's, which would have allowed insurance companies to own banks, a fairly novel idea at the time. We came back and said that we should be able to own insurance companies, and the governor and the legislature said we can't solve this, let's have a commission.

And what came out of that commission, quite frankly, were many of the provisions that are in H.R. 10 today. They were never passed in New York, I might add, over 15 years. And quite frankly, it was only the court cases in the last three years that brought forth all the changes both in New York and in the provisions in H.R. 10.

Mr. SWEENEY. I have one final question for Mr. McQuillan. Mr. Jones has spoken to the advantages of having choice and some of the competing regulatory structures, if that is a fair characterization, whether it is op sub or the holding company structure. Could you indicate to me what you think some of the deficiencies are? How does having different regulatory frameworks in any way undermine the goals of making the financial services industry more competitive?

Mr. MCQUILLAN. Well, this speaks to—I mean different regulators are in my mind a viable alternative of the system and should continue. But as it relates to these—what we have deemed riskier activities, merchant banking, insurance underwriting, securities underwriting, those types of things, we feel that they should be pushed out of the op sub and put into the bank holding company, and that there should not be a choice there as it relates to those activities. That is what I was speaking to.

Mr. SWEENEY. OK. I yield my time.

Chairman LEACH. Mrs. Jones.

Mrs. JONES. Good afternoon. Stephanie Jones from Cleveland, Ohio, District 11.

First of all, I want to say that I am so glad to see E. Lee Beard seated at these tables. It is not that I don't like good-looking men, but it is nice to see that the banking industry has allowed women to make it to the top. So I want to applaud you for being at the table on behalf of all of the women who bank all of our money.

I would say I have a question with regard to the testimony of everyone seated here, though I didn't hear, I tried to cursorily read through it. With regard to no discussion with regard to consumer protection or the Community Reinvestment Act, can I be—can you be heard at least briefly on those two issues, please, each of you, or your representative, whichever you choose?

Mr. JONES. I would be happy to start, Congresswoman. Currently, I think consumer protection issues are addressed in this bill. There are lots of disclosure issues included here which go down the road that you are talking about. I think any time we talk

about consumer protection issues, we have to strike a balance between access to those services and protection of the consumer.

Now, what do I mean by that? What I mean is that if we take a look at some of the real estate laws that are in place today, some of the regulations that banks and thrifts have to comply with, the consumer is asked to read and sign literally inches of paper, most of which the consumer never reads. It makes access more difficult; it makes the costs go up. But certainly reasoned consumer protection is something that we as an industry do agree with.

Relative to the CRA issue that you bring up, the CRA issue, I would defer to what John McCoy said to you early this morning, and that is that the intent of CRA is not something that the banking industry disagrees with. What the industry has disagreed with over time is the evolution of CRA into really a paper based compliance system as opposed to something that really drives change and capital into the neighborhoods of this country. That is what we oppose.

We would not oppose a bill that had neutral CRA provisions in it from what the law stands today. Because, again, I go back to my earlier comments to say that the most important thing to us is to advance financial services reform.

Mrs. JONES. I don't know quite how much time I have. Would you explain to me what you mean by neutral CRA provisions for me, please?

Mr. JONES. No additional CRA provisions, no expansion of CRA beyond its current structure.

Mrs. JONES. Because?

Mr. JONES. Because every time we do that, as we have several times over the years since 1977, it has become more and more a bureaucratic nightmare for banks as opposed to something that drives performance into the communities.

Mrs. JONES. Do you have a study that speaks to that issue that is more bureaucratic than driving support within communities?

Mr. JONES. Well, we certainly can show you the evolution of CRA over time and how it has become more bureaucratic. I still go back——

Mrs. JONES. The thing I am trying to be clear on with regard to CRA—and keep in mind, I am new at this. But in Cleveland, at least it seems that we are seeing a greater activity in our communities in terms of development, people moving back into the city, opportunities for reinvestment.

So I am just suggesting that maybe it might not be necessarily the statutory implementation of CRA or the paperwork, but it may be the way in which it is administered in particular communities, and it looks like I am almost out of time. But could you respond to that for me, please?

Mr. JONES. I sure can. Actually, I go back to my initial statement where I said the intent is not wrong in anything that we disagree with. I think what financial institutions have understood for some time, although maybe not back in 1977, is that development, community development lending and lending of all kinds in low to moderate income communities is, in fact, and can be very good business for the banking industry.

And so I believe that is what is driving this more than the paperwork that is developed behind CRA. We are making more loans in the communities of this country because it is good business.

Mrs. JONES. OK. Mr. Chairman, could I have one more minute?

Chairman LEACH. You have a little bit of time left.

Mrs. JONES. I still have time left.

Again on CRA, how do you monitor or measure the accountability for CRA within your institution? The only gentleman I have been talking to, thanks.

Mr. JONES. In our institution, we go through quite a bit of analysis on how we are lending within our community. We look at not only where we take deposits from each different area within the community, but also where we make loans in each different area of the community. In addition to that, we look at some things that aren't even envisioned in CRA.

We look at the amount of contributions that our organization is making to worthwhile community activities. We are looking at mentorship programs and all sorts of other things that are outside the bounds of CRA. But to answer your question——

Mrs. JONES. Are you seeing any benefit from it?

Mr. JONES. Are we seeing a benefit from CRA? I will tell you we would do exactly the same thing even if CRA were not there, and the reason that we would is that it is good business, and it is the right thing for the community.

Mrs. JONES. Break my heart, now come on.

Mr. JONES. I am serious. I am serious.

Mrs. JONES. Now that you know that CRA is important to the United States. But prior to its enactment, you couldn't make that statement, could you?

Mr. JONES. I think I was only 22 years old prior to that.

Mrs. JONES. Speaking for your institution, OK? I am out of time.

Mr. MCQUILLAN. Could I add one thing?

Mrs. JONES. Please.

Mr. MCQUILLAN. I am from a community of about 600 people. And I have been in larger banks and small banks, and I think banks are committed to CRA, certainly most of our banks across this country invest in our communities, I mean it is good business. There might be certain spots in this country that might not be as committed as others and certainly you are probably referring to some of those. But I can tell you that in my community, if the bank—if I wasn't there, the community wouldn't survive. I mean I am the only bank in the community. And we do this day in and day out and we live with it.

Let me add one more point that Scott didn't, and I agree with his thought. And that is on WFIs. We have WFIs on this bill, and I believe that any institution that operates in this financial world should have to have the same type of regulations that the rest of us do. So I would think that WFIs should have that situation also—and credit unions.

Mrs. JONES. Anyone who didn't get a chance to respond to me, I'm sure that somebody in the back would like to say that. I would request anyone who did not have an opportunity to respond orally to me to submit some responses in writing for the record. I would be appreciative.

Thank you, Mr. Chairman.

[The information referred to can be found on page 401 in the appendix.]

Chairman LEACH. Well, thank you, Mrs. Jones.

Mrs. Biggert.

Mrs. BIGGERT. I seem to have lost the microphone. Thank you, Mr. Chairman.

I would like to ask just one question of Mr. Jones, and I am from a State, Illinois, that has had—probably was one of the last States to have branch banking, and then is very viable I think with the financial institutions, but we have had an awful lot of mergers and consolidations of banks and ownership by foreign banks. And I was just wondering is what do you think of the—is there any impact, if we were not to pass a comprehensive financial modernization bill with respect to U.S. banks' ability to compete internationally?

Mr. JONES. I am glad that question surfaced. I will tell you that the biggest defense that any banking organization has, whether it is large or small, to being taken over by another institution, foreign or domestic, is good strong earnings performance. In our particular organization if we generate the proper returns for our shareholders, they are quite happy with their investment and don't need to look elsewhere for a new owner.

Having said that, what H.R. 10 does is allows the banking industry to diversify its earnings stream, to generate new sources of revenue that will not only supplant, but hopefully exceed some of the lost revenues coming from smaller spread income between the traditional banking side of our business. So it is a terribly important thing to defend against being taken over, but also to generate more safety in the system, because of greater and more diversified earning streams.

Mrs. BIGGERT. Thank you. And then, Mr. Smith, I know we will have a panel on insurance. But from the banking community, as far as selling insurance—I know that in H.R. 10 last year, I was not here, but having been involved in banking and the issue of insurance in Illinois, and I know that there were certain standards that were set forth in that bill and understood that that was somewhat of a model for developing the insurance part of this. And it is my understanding that those standards are no longer included in this, and why the change in that?

Mr. SMITH. No, you are correct, Congresswoman, that the Illinois standards actually were the standards, most of them, coming out of the House. And that was really an earnest negotiation in the House; however, when it got out to some of the States, not just New York, but other States, looking at those so-called safe harbor features, they were more extensive, they were more burdensome than some of the features that existed in New York and other States. For example, they required separate facilities, issues dealing with disclosure, cross marketing, that created problems.

And the concerns that States like ours had was that these features then would put pressure on the New York State legislature to mirror the Illinois statute and then Illinois law would become the law of the land. So, therefore, it was through negotiation and discussion with all the parties that we agreed on a set of features, some of which include the Illinois features and features from New

York and other States. So the Illinois standards were not just discarded.

Mrs. BIGGERT. So you think that some of the concerns of the insurance regulators and agents and certain consumer groups that the standards that are in there now are——

Mr. SMITH. Let me just say for the State of New York, which includes all of those parties, the consumer groups in New York, the State legislature, the insurance department, companies and agents all supported these features as part of New York law two years ago and signed off on it. So, you know, that element of the industry and then our group, the individuals in our group, also signed off as national organizations. Many of the provisions, Congresswoman, include the consumer protection items.

Mrs. BIGGERT. Thank you.

Thank you, Mr. Chairman. I yield back my time.

Chairman LEACH. Well, thank you. I am glad that a citizen of Illinois is defending the State's judgment versus a New Yorker.

But please, Mr. Green.

Mr. GREEN. Thank you, Mr. Chairman.

I guess I just have one question at this point, it is for Mr. Smith. Now, your organization obviously represents a diverse group of banks. Comment, if you will, on why you consider closing the unitary thrift charter loophole to be so important to this legislation?

Mr. SMITH. It has been discussed earlier, and I concur certainly with Mr. Jones, because our association supports the bill. We believe it is very important, especially to community banks throughout the country. We would concur with the Chairman's statements at the outset. We can recall the deposit insurance issue, the so-called Frist amendment, dealing with the mergers of the charters and the mergers of the funds.

Quite frankly, the New York Bankers Association supports so-called chartering up, which is taking the best features of all the Federal institutions and putting them into one charter. However, those features or any discussion of that was dropped in the final House version in 1997.

We believe what we have today to be a compromise. It doesn't do away with the unitaries. It has grandfathered certain unitaries at a date certain. And we feel it is extraordinarily important to the community banking sector throughout the country. What was agreed to in the Senate is a date certain for closing the loophole and you can't sell a unitary to other commercial firms. That will allow us at some point in time to deal with the broader charter issue, which quite frankly we do not believe at this time or in this bill will be resolved.

Mr. GREEN. Thank you, Mr. Chairman. I yield back the balance of my time.

Chairman LEACH. Thank you, Mr. Green.

Mr. LaFalce.

Mr. LAFALCE. Thank you very much, Mr. Chairman.

First of all, I want to congratulate my long-standing friend from the State of New York, Mr. Michael Smith. Michael and I have known each other for a long time. And I honestly think, Michael, you are more responsible than anybody else in this room right now for the advancement of financial services modernization and you

did tremendous work, especially toward the end of the session, working so closely with the office of Senator D'Amato and Howard Minell and the predecessor to Howard Minell, Neal Levin, who wore two hats, banking superintendent of New York State and then insurance superintendent.

But I am also a bit aware of the evolution of thinking that has taken place within the New York State Bankers Association prior to summer, fall of October 1998 when there was considered an imperative need, prior to the decision of Citicorp and Travelers to merge, and so forth. And it is always interesting to see how perspectives can change, depending upon a changed environment.

But we have advanced considerably and because of your great work, Chairman Leach and I have much in common in our respective bills. So much of it, his bill and my bill, is based upon that work, that work product, much more in common than we differ on.

All right. Now having said that, let me ask a few little questions. Congresswoman Kelly wanted some yeses or noes. And I will try not to be quite that bad. But let me just say, Mr. Jones, pro-choice or anti-choice? Operating subsidiaries, pro-choice, anti-choice?

Mr. JONES. Our position is for the greatest flexibility that would seem to suggest—I just can't use the word. We would be for choice.

Mr. LAFALCE. OK, good. So you indicated to Congresswoman Kelly that you could support H.R. 10. Would you support it more enthusiastically if you had choice with respect to corporate governance?

Mr. JONES. This is an issue that is fairly far down on our list of priorities. We could support the bill either way.

Mr. LAFALCE. Let me ask you this. Would you prefer to have a bill sent to the President that the Secretary of the Treasury would recommend signing or would recommend vetoing? What would your preference be?

Mr. JONES. That is a very clear question, and I would prefer a bill that could be sent that could be signed.

Mr. LAFALCE. All right, good, thank you. Now, let me go on and ask a few more questions. The Independent Bankers Association, just back to operating subsidiaries. Now, was there an evolution in the thinking of the IBAA at one time, did the IBAA really want operating subsidiaries, and then did they change their mind and say, now, somehow we have seen the light and don't want operating subsidiaries? Did you go from a pro-choice to an anti-choice position?

Mr. MCQUILLAN. There is an evolving process.

Mr. LAFALCE. I just want to understand the evolution of it.

Mr. MCQUILLAN. I'm sorry?

Mr. LAFALCE. I want to understand the history of it. Am I correct that at one time you favored the operating subsidiary approach and then there was a change in thinking?

Mr. MCQUILLAN. As it related to the risky activities, I am not aware of that.

Mr. LAFALCE. OK. Good. Let me go on. I am going to come to you a little bit later, Ms. Beard.

Mr. Fink, I think you would favor greater choice and corporate governance.

Mr. FINK. No, we don't have an opinion one way or the other.

Mr. LAFALCE. You don't have an opinion. OK. You want no choice. Let me ask something else though, and that is the whole question of the potential for some relationship between banking and commerce. I mean that exists right now. I mean it exists to a certain extent on a State level through State chartered institutions. It exists to a certain extent on a national level with respect to operations overseas, with respect to domestic banks. It exists with respect to SBICs. And it has existed historically with respect to the unitary thrift holding companies.

Do you favor an approach that would permit a continuation at least of the experimentation that we have had?

Mr. FINK. Even more strongly. Because if I can, Congressman LaFalce, I think a problem is that you have had this bar for banks; you have never had it for securities firms; you have never had it for insurance companies, I believe. And I represent mutual funds. We started in 1924, and there were a series of mutual fund groups that have historically had commercial affiliates.

So we have never had a commercial prohibition. Now Congress may say "we are going to create a brave new world, we are going to have all of these different financial firms able to affiliate." And I am lost as to why we automatically choose the banking model as the model and now we have to talk about whether we vary from a banking model. If I were doing it, with all due respect, I would probably have no bar, because that is the world I grew up in.

But in the interest of compromise, I would think a basket would be appropriate at least to accommodate those mutual fund and other non-bank firms that have had commercial affiliates with no problems for decades—for 50 years. Why suddenly say they have to be stopped when there is no evidence of abuse? It hits me that a basket, I don't know if that is what you are asking for, or some exception, is the least that ought to be done.

Mr. LAFALCE. Or at least don't go backward.

Mr. Smith, you said something, you said you cut a deal in an accommodation based upon your—but you really favor charting up whenever we could get to it. You said that. I think you used the phrase chartering up. What do you mean by chartering up, Mr. Smith?

Mr. SMITH. Well, I think it is a word of art that people have used for some time now to say to take the best features of all the various charters, like they have I believe in Maine, where they have a universal bank charter.

Mr. LAFALCE. Does that mean you sort of like some of the things that the thrifts or unitary thrifts can do and you wouldn't mind having them for yourself?

Mr. SMITH. The question was within the context of the unitary feature and how it is treated in H.R. 10. I believe the industry, meaning the banking industry, not our group, never got in Washington to the point where you were dealing with the charter and you had agreements on a charter proposal. And I know you had a provision in the House Banking Committee, but it was deleted so, therefore, all the features regarding the thrift charter were knocked out, and the one thing that was left that was of most importance as a residual was what do you do you about the unitary?

Mr. LAFALCE. Would I be unfair, Mr. Smith, if I characterize your position as this: You really like chartering up, that is, what the unitaries have at least. But until such time as you get them, you don't want them to have them, and you feel maybe the best way for you to get chartering up is to charter the others down first?

Mr. SMITH. Well, what we would like to do, quite frankly, Congressman, and I appreciate your remarks——

Mr. LAFALCE. No, you don't.

Mr. SMITH.—I appreciate your earlier remarks.

Mr. LAFALCE. OK.

Mr. SMITH. I can tell you what we would like. We would like to have a bill. We support a bill, the industry is deeply concerned, the banking industry and Scott Jones has already said this, the industry is deeply concerned about the unitary thrift. We do not believe that the issue of the overall charter is going to be dealt with at this time. And, therefore, as it is treated in the current bill is something that we support as an industry, and we strongly support, and leave it at that.

Mr. LAFALCE. Fine. I think my time has expired. The Chairman has been indulgent.

So, Ms. Beard, if you don't mind I won't ask any questions.

Ms. BEARD. Not a problem.

Chairman LEACH. Mr. Gonzalez, would you like to ask some questions?

Mr. GONZALEZ. No questions. Thank you.

Chairman LEACH. I think that brings this panel to an end. And let me thank you all and let me just stress to Ms. Beard that I wish to separate personality from words.

Ms. BEARD. That is very important.

Chairman LEACH. And I can't think of an institution that I would rather have an account with than one that you head.

Ms. BEARD. Thank you.

Chairman LEACH. But I apologize for having some difference with your association's position.

Ms. BEARD. I think that is an important part of this process, is to be able to bring those differences forth and to deal with them honestly.

So I thank you for the opportunity.

Chairman LEACH. Very well. Well, thank you all. I appreciate it very much.

On our third panel we have representatives of all facets of the American insurance industry. Our first panelist would be W. Neal Menefee, who is President and CEO of Rockingham Group Insurance Companies on behalf of the National Association of Mutual Insurance Companies; followed by Mr. William B. Greenwood, who is President of the Lawton Insurance of Central City, Kentucky, and President of the Independent Insurance Agents of America; Mr. Mark A. Pope, who is Vice President and Director of Federal Relations for the Lincoln National Corporation for Fort Wayne, Indiana, on behalf of American Council of Life Insurance; Mr. Harry Rhulen, who is Chairman, President and CEO of the Frontier Insurance Group, Rock Hill, New York, on behalf of the American Insurance Association; and finally, Mr. James J. Kilbride, who is Chairman and CEO, Morse, Payson & Noyes Insurance, Portland,

Maine, and Chairman of the Council of Insurance Agents and Brokers.

We will begin with Mr. Greenwood. Mr. Greenwood, if you could take the microphone and hold it close. Thank you.

STATEMENT OF WILLIAM B. GREENWOOD, PRESIDENT, LAWTON INSURANCE, CENTRAL CITY, KY, AND PRESIDENT, INDEPENDENT INSURANCE AGENTS OF AMERICA

Mr. GREENWOOD. Let me briefly change my script from good morning, Mr. Chairman and Members of the committee to good afternoon. My name is Bill Greenwood, and I believe I have a unique distinction of appearing before you today as a working member of both the insurance and banking communities.

In my role as an insurance agent, I am President of Lawton Insurance Agency which is located in Central City, Kentucky, and I serve currently as President of the Independent Insurance Agents of America.

On the banking side, I am President of First United Bank Holding Company and a member of the board of directors of the Central City First National Bank. I am testifying today on behalf of the Independent Insurance Agents of America and the National Association of Life Underwriters, who together represent virtually all of the insurance agents in this country.

First, Mr. Chairman, let me thank you again for holding these hearings. We have been working for many years on different financial reform proposals, and we have been before your committee on numerous occasions. And certainly I know you hope that this possibly might be the last time.

We have only one basic concern in this bill: Ensure that every entity that is involved in the insurance business is subject to State regulation. Federal banking regulators are in no position to substitute for the comprehensive State insurance laws that have been developed over the last 100 years.

The version of H.R. 10 that you helped shepherd through the House last term, Mr. Chairman, was a bill that we supported because it would have provided some clarification and some certainty. As you know, the bill that is now before you, the 1999 version of H.R. 10, includes some of the positive elements that were included in the 1998 House bill.

Sections 301 through 303, for example, include several provisions designed to ensure that everyone, including national banks, that engages in the business of insurance must comply with State insurance laws and regulations. For preemption challenges to State insurance laws enacted in the future, Section 306 stipulates that when a State insurance commissioner is challenged by a Federal banking regulators' view that a State law should be preempted, the view of both the State insurance regulator and the Federal banking regulator should be given equal consideration. H.R. 10 would thus go part way toward preserving the functional regulation of insurance.

The proposal also would, however, jeopardize many of the consumer protections already in place in many States that protect the very consumers that this legislation is designed to serve. Agents believe that four changes would correct these shortcomings.

First, the proper preemption of standards should be clarified. State officials are unclear as to what constitutes significant interference within the meaning of the Supreme Court's *Barnett Bank* decision, and this issue is destined to be the subject of protracted litigation.

Such litigation could be averted if the Section 104 preemption provision clarifies that State insurance law are preempted only if they actually and constructively prohibit national banks or bank-affiliated entities from exercising their Federal authorized insurance sales powers.

Second, the so-called "nondiscrimination provision" should be removed from the bill. As over 25 States and the OCC itself have previously recognized, the sale of insurance by federally insured banks creates unique problems that require consumer protections tailored for that context. Although the safe harbor provisions are an effort to capture many of major regulatory controls that currently are in place, they are too limited in that many existing State laws would go unprotected and they could not possibly take into consideration the wide array of issues that would require significant regulatory solutions.

Third, clarify that State insurance regulators are entitled to receive consideration of their views in court when disputes arise between regulators, regardless of when a State law challenged on preemption grounds was enacted. The bill, as currently drafted, permits the views of State insurance regulators to be considered only in court challenges to law enacted in the future. The inevitable difference in any OCC preemption opinions regarding current laws would place many long-standing State laws in jeopardy.

The OCC, however, simply has no expertise in the regulation of the business of insurance, and no special consideration of the OCC's views should be endorsed in the bill.

Fourth and finally, strengthen the safe harbor provisions to ensure that, at a minimum, they protect all the valid State laws and regulations of bank sales of insurance that are currently in place.

Mr. Chairman, I or our counsel, Scott Sinder, would be happy to address any questions that you have.

[The prepared statement of William B. Greenwood can be found on page 403 in the appendix.]

Chairman LEACH. I thank you very much, Mr. Greenwood.

Before turning to Mr. Pope, I am not sure I remembered to introduced Mr. Creighton, a member of the panel. And David Creighton is President of Bryton Companies of West Des Moines, Iowa on behalf of the National Association of Professional Insurance Agents. And we will get to you in a minute. But I failed in the first introductory round, I apologize.

Mr. Pope.

STATEMENT OF MARK A. POPE, VICE PRESIDENT AND DIRECTOR OF FEDERAL RELATIONS, LINCOLN NATIONAL CORPORATION, FORT WAYNE, IN, ON BEHALF OF THE AMERICAN COUNCIL OF LIFE INSURANCE

Mr. POPE. Thank you, Mr. Chairman. Good afternoon, Members of the committee and staff. My name is Mark Pope; I am Vice President and Director of Federal Relations for Lincoln National

Corporation, located in Fort Wayne, Indiana. I am appearing today on behalf of the American Council of Life Insurance, the principal trade association for the Nation's life insurance companies.

Mr. Chairman, it has been said before, but I want to say it again at the outset, I want to sincerely applaud you for your tireless efforts to bring financial modernization legislation back to this committee. Without the type of leadership and commitment that you have shown, this process would have been at a dead stop. We are greatly encouraged by your dedication, and we look forward to working with you to bring this bill through the committee and see it through to its final completion.

Last year, building on the foundation produced on a bipartisan basis by this committee under your leadership, the principal trade groups representing insurance companies, agents, banks and securities firms joined in an historic agreement to support H.R. 10. Now, time ran out on the attempt to bring that bill to the Senate floor, but fortunately, however, the agreement between the industries remains intact and has been embodied in H.R. 10 as reintroduced by you this year.

The bottom line is that we support it as introduced.

Now, it isn't perfect from anyone's perspective, nor is it necessarily the only way to accomplish needed reforms. However, it is fair, and it is the only financial modernization proposal which has the broad industry support that is necessary to achieve enactment.

The principal provisions of H.R. 10 were painstakingly developed over the last two years as its predecessor bill made its way through this committee, the Commerce Committee and the Senate Banking Committee. Almost every provision was the product of extensive debate among insurance companies, agents, regulators and others; for every provision that was agreed upon, a dozen or more others were considered and rejected.

For that reason, departures from the insurance language in H.R. 10, no matter how seemingly minor or well intended raise substantial risk that they will upset the delicate balance which was achieved last year. And as we know, opposition from any major sector of the financial services industry could drastically reduce the prospects for legislation in this session. That is a situation that we all wish to avoid.

Dynamic changes in our marketplace are continuing to occur. If these changes are not guided by a comprehensive modernization plan, the result will be regulatory anomalies and competitive inequities, which will make any future consensus that much more difficult to achieve. Now is the time to act, and we believe H.R. 10 is the vehicle.

Mr. Chairman, while we are squarely behind the major provisions of H.R. 10, we believe that there are a few areas in which it may be significantly improved without disturbing the consensus for its enactment. Let me cite one example that has been touched on briefly by Mr. Vento and Mr. Hill.

Currently, State insurance regulators are changed by law with the responsibility for protecting the interest of policyholders whenever there is a change in control of an insurance company.

Under current law, State insurance regulators have broad authority to approve, disapprove, or condition a transaction under

which a change of control of an insurer would take place. H.R. 10 would radically diminish the State's authority in this regard providing only that the Federal Reserve Board be in a position to disapprove an insurer-bank affiliation transaction. Our concern here is that H.R. 10, as drafted, contains no guidance or explicit statutory authority directing the Fed to consider the merits of an appeal from an insurance commissioner.

We believe that it is absolutely essential to require—that the law require that the Fed, as the umbrella regulator, consider a number of specific factors when it finds itself in the position of reviewing an insurer-bank affiliation. We, therefore, believe that H.R. 10 should be amended to provide that the Fed must solicit the views on such an affiliation transaction from the insurance regulator in the insurer's State of domicile and that in reviewing that transaction from the perspective of the best interests of the policyholders consider four factors which were included on pages 9 and 10 of my written statement.

In closing, Mr. Chairman, we would only add that the need for this legislation is clear, the principal provisions are not in dispute, and there is no rationale for further delay. Here is an opportunity for Congress to enact historic legislation on a bipartisan basis that has broad support among the affected parties.

We certainly look forward to working with the Chairman and the other Members of this committee to complete the finishing touches on H.R. 10 and send it to the House floor.

[The prepared statement of Mark A. Pope can be found on page 417 in the appendix.]

Chairman LEACH. Well, thank you very much, Mr. Pope.

Mr. Rhulen.

STATEMENT OF HARRY RHULEN, CHAIRMAN, PRESIDENT AND CEO, FRONTIER INSURANCE GROUP INC., ROCK HILL, NY, ON BEHALF OF THE AMERICAN INSURANCE ASSOCIATION

Mr. RHULEN. Good afternoon, Mr. Chairman. I am Harry Rhulen, CEO and Chairman of the Frontier Insurance Group, headquartered in Rock Hill, New York. And I am honored to be here this afternoon representing the member companies of the American Insurance Association.

We also would like to commend your continuing efforts to make financial services modernization a reality. Because of this committee's leadership and nearly 20 years of effort, we are just about there.

Why is this issue so important? Well, as the Chairman pointed out, the Depression Era statutory barriers between banking and other financial services are stifling growth and innovation in the financial services sector.

In the absence of a rational and relevant statutory framework, our sector will continue to be shaped by ad hoc regulatory and court decisions that create competitive disparities among firms. We believe that H.R. 10 creates a viable regulatory framework and establishes a level playing field among financial services participants.

It provides new opportunities for providers, increases consumer choice, and improves the international competitiveness of U.S. firms. Most importantly, and I don't think this can be understated,

this is achieved while assuring the safety and soundness of our Nation's banking, insurance and securities systems.

In 1997, the American Insurance Association was one of the first groups to endorse the prior version of H.R. 10, and we are proud to have been able to help shape the reforms as they moved through Congress. After two years of tremendous hard work and compromise by all participants, we came very, very close to passage. Time just ran out.

The AIA is proud to be here this year and we are delighted that financial services modernization remains a top priority for this committee and this Congress. The momentum remains intact.

Virtually all segments of the insurance industry, not to mention banking and securities, support modernizing our financial services regulatory structure. We recognize that certain changes to the bill are likely this year. But we urge that the final proposal maintain overall balance so that it will maintain the same broad support. This is more than a matter of convenience. The principles of H.R. 10, as currently drafted, are the right principles for fair and effective financial modernization.

I would like to quickly emphasize two of these principles that are critical to the fair and safe conduct of insurance in the new, highly competitive environment that H.R. 10 will foster. First, insurance regulators must be authorized to define insurance; and second, financial services modernization must include equitable dispute resolution standards and procedures. Both principles are necessary for success and one without the other would create a toothless and self-defeating type of legislation.

We believe strongly in the principles of functional regulation allowing Federal bank regulators to oversee bank products and State insurance regulators to oversee the business of insurance. In order to create a viable system of functional regulation, Congress must establish an appropriate process for defining both banking and insurance.

H.R. 10 represents a carefully negotiated compromise between the regulatory and private sector interests at stake. On the insurance side, it preserves State insurance regulators' authority to define existing insurance products, and most insurance products offered in the future. Banks retain the ability to offer any banking or insurance product that they are authorized to offer or were lawfully providing as of January 1st, 1997.

The insurance definitions of H.R. 10 provide the critical foundation for functional regulation. Moreover, they do not restrict the extent to which banks can affiliate with insurance companies and thus underwrite insurance products that are properly subject to insurance regulation. These provisions do, however, prevent banks from underwriting new insurance products that are not subject to insurance regulatory oversight.

H.R. 10 ensures that the banking regulators, including the OCC, do not ignore the principle of functional regulation by redefining banking activities to include the business of insurance. Under any definitional scheme, disputes between banking and insurance regulators will arise as to whether a particular product is insurance or banking. H.R. 10 assures a fair means of resolution that preserves the principle of functional regulation.

H.R. 10 provides that the Federal courts will decide disputes between regulators on the merits without unequal deference to either party. Three key provisions make this workable: the right for banking and insurance regulators to challenge one another's product definitions, expedited judicial proceedings, and the requirement that courts decide disputes on their merits without granting unequal deference to either State or Federal regulators. Taken together, this strikes the appropriate balance between the authority of the OCC as the supervisor of national banks and the ongoing role of the States in regulating insurance.

Again, this also reflects the principle of functional regulation underlying H.R. 10.

Mr. Chairman, I would like to conclude with some personal words. Although I am here representing the AIA, Frontier Insurance is not one of the giants you read about or have heard from today. We are a mid-sized and growing company that in 1977, through hard work and innovative products, broke into the top 100 property and casualty insurance groups based on net written premiums.

H.R. 10's passage is an important key to our continued growth. Its enactment will allow us to continue to flourish, based on our own skills and our entrepreneurial spirit. H.R. 10 is about mid-sized firms competing with the biggest to provide products and services to the American public secure in the knowledge that we are operating in a fair and predictable regulatory environment that is good for us, good for our consumers, good for competition, and good for the economy.

On behalf of myself, Frontier's 1,300 employees, our 3,000 agents, our policyholders and the 300 member companies of the AIA, I respectfully urge H.R. 10's prompt passage, and offer any assistance we can toward that end.

Thank you.

[The prepared statement of Harry Rhulen can be found on page 431 in the appendix.]

Chairman LEACH. Thank you very much, Mr. Rhulen.

Mr. Kilbride.

STATEMENT OF JAMES J. KILBRIDE, CHAIRMAN AND CEO, MORSE, PAYSON & NOYES INSURANCE, PORTLAND, ME, AND CHAIRMAN, COUNCIL OF INSURANCE AGENTS AND BROKERS

Mr. KILBRIDE. Mr. Chairman and Members of the subcommittee, thank you for this opportunity. I am Jim Kilbride, Chairman and Chief Executive Office of Morse, Payson & Noyes Insurance of Portland, Maine.

I am also the 1999 Co-chairman of the Council of Insurance Agents and Brokers, and I am here today representing that organization. That organization is an association that represents the Nation's largest commercial insurance agencies and brokerage firms.

My interest in the issues associated with financial services integration is more than academic. In 1997, our firm, the largest insurance agency in Maine, was purchased by the largest bank in Maine, Peoples Heritage Financial Group.

I have been in the business almost 40 years, so I know many of our industry have misgivings about banks selling insurance. But I can report to you that our venture is providing a terrific synergy of talents and capabilities. Both our banking and insurance clients are benefiting from this affiliation.

I am here though to testify specifically on Subtitle 6 of Title III of H.R. 10, the provisions regarding the creation of the National Association of Registered Agents and Brokers, commonly known as NARAB. These provisions were initiated in this committee by Congresswoman Kelly in the last session of Congress and supported on a bipartisan basis.

We are grateful to Chairman Leach for the continued presence of the NARAB provision in H.R. 10 this year, and we strongly urge its adoption.

Here is the problem and why NARAB is a good start on a solution: Whether we like it or not, consolidation is occurring throughout the financial services community, and with consolidation, the volume of interstate transactions is increasing tremendously. As you improve the laws governing regulation of these industries, Congress should assist in the modernization of laws and regulations that inhibit competition and add unnecessary costs to consumers. Agent and brokerage insurance licensing laws are badly out of pace with the marketplace of 1999, and they need to be modernized.

Licensing for insurance agents is a State-by-State, line-by-line, class-by-class, producer-by-producer situation. In order for an agent or a broker to be able to service national accounts, he or she may literally have to obtain literally over 100 licenses, each with their own different criteria.

The standards of professionalism required to get these licenses aren't all that high. But the redundancy, inconsistency and hassle factors are extremely high. More problematic than the duplication though are the numerous protectionist residency barriers that exist in the States. While some States have open markets, others are closed. Some States, for example, bar agents from soliciting or selling insurance in their State.

In a world marketplace, these are trade barriers. They are also barriers to domestic interstate competition. The concept of NARAB is to provide a clearinghouse for the interstate licensing of insurance agents and brokers and to remove unjustifiable barriers to competition. It is totally voluntary and totally self-financing. This is not a way to bypass State licensing qualifications. No one would be admitted into NARAB who isn't already eligible to receive a license in their home State.

There are numerous provisions in H.R. 10 that would assure that NARAB fits comfortably with State insurance regulation, and these are described in my formal testimony.

I should note, though, that the bill allows the NAIC to run NARAB. As much as I would like Congress to enact NARAB as a licensing clearinghouse, there is an even more important provision within the NARAB subtitle.

Under H.R. 10, the States would have three years in which to avoid the creation of NARAB. If only 26 States adopt reciprocal licensing statutes in three years, there will be no NARAB. This is

a low threshold and attainable. It is an incentive for the States to act and it should be readily achievable.

In conclusion, I would like to say that since NARAB was first put on the table in this committee two years ago, the NAIC has increased its attention to the problems of State-by-State licensing. They are pushing an agenda of uniform treatment for resident and nonresident agents and brokers, and their efforts are important and appreciated.

Finally, interstate licensing is as much of a problem as it ever has been. Our trade association started working on this issue in 1939, urging uniformity, reciprocity, and free and open trade. We have still got a long way to go.

The NARAB provisions of H.R. 10 are the incentive necessary to make progression on licensing reform. It is important for this incentive to remain a part of financial services modernization. We appreciate this committee's support for the provision of the past and look forward to its enactment in the future. And we thank you.

[The prepared statement of James J. Kilbride can be found on page 442 in the appendix.]

Chairman LEACH. Thank you, Mr. Kilbride.

Mr. Creighton.

STATEMENT OF DAVID O. CREIGHTON, SR., PRESIDENT, BRYTON COMPANIES, WEST DES MOINES, IA, ON BEHALF OF THE NATIONAL ASSOCIATION OF PROFESSIONAL INSURANCE AGENTS

Mr. CREIGHTON. Chairman Leach and Members of the committee, my name is David O. Creighton, Sr. I am the President of the Bryton Companies, a financial services company in West Des Moines, Iowa. I am also a partner in a small rural property casualty agency. I serve on the National Association of Professional Insurance Agents board of directors and act as the President of its services corporation. PIA is a national trade association representing the interests of over 180,000 independent agency brokers and their employees across this country. I bring a focus of both agents and consumers to these discussions.

I am pleased to have the opportunity to address you today about H.R. 10 and the important issues surrounding comprehensive financial reform, and I congratulate Chairman Leach, a fellow Hawkeye, and Ranking Member LaFalce, for holding this public hearing.

H.R. 10 will dramatically reshape the financial services industry and the ability of States to regulate the insurance sales activity, as well as protect the consumer. Having lived and worked in a place where banks and insurance agents have competed for many years, I can reaffirm the need for a level playing field throughout this country.

PIA and agents everywhere strongly believe that State insurance regulation must be preserved to ensure consumers remain adequately protected. At the heart of the current debate about bank involvement in the insurance activity is the question of functional regulation. Everyone endorses such regulation but views it differently.

PIA supports functional regulation, by which we mean that the States have the authority to regulate the insurance sales activity of everyone, including banks. The client-consumer expects that as well.

Prior to the mid-1980's, there was never a question that States had the authority to regulate national banks and insurance sales activities. It never occurred to anyone that an agency or an agent was free from State regulation simply because the agent was affiliated with a national bank. This all changed with the *Barnett* decision which, on one hand, said States couldn't prohibit national banks from selling insurance, but on the other hand created an ambiguous standard on how States might regulate those insurance sales.

Contrary to what you may have heard, PIA does not question the rights of banks to sell insurance so long as they do so under the same rules and regulations that we face. Our objective in both the House and Senate has been to resolve the ambiguity created by *Barnett*, and in doing so, avoid potential lengthy litigation as well as eliminate the possibility that the OCC will displace State regulation in bank insurance sales activities.

H.R. 10 includes a number of provisions supported by PIA and the agent community at large. For example, Sections 301 through 303 reaffirmed the concept of functional State insurance regulation and the principles embodied in the McCarran-Ferguson Act. The safe harbors included in Section 104 are also helpful, and we applaud the committee for including these provisions.

Unfortunately, when taken in its entirety, H.R. 10 jeopardizes many existing State consumer protection laws.

PIA believes H.R. 10's shortcomings could be improved by the following four changes: One, the committee should eliminate the nondiscrimination provision; two, clarify that State insurance regulators receive equal consideration of their views in court; three, clarify the proper preemption standard; and four, strengthen the safe harbor provisions.

The nondiscrimination provision contained in Section 104(c) should be removed from H.R. 10. Currently, over 25 States and the OCC itself have recognized the sale of insurance products by financial institutions creates unique problems that require tailored consumer protections. These laws are not anticompetitive nor are they driven by the desire to keep banks out of the insurance business. They merely recognize the unique aspect of bank insurance sales operations and attempt to create a level playing field between banks and non-bank insurance agents while protecting the consumers from potential abuse.

One only needs to look at Federal anti-tying provisions that prevent banks from pairing the extension of credit with the purchase of insurance to understand why States might enact laws that treat banks differently. Indeed, the OCC itself has recognized that there are many instances in which discriminatory regulation in the sense of treating banks differently than non-banks is appropriate and necessary. Consequently, there is no basis to argue that consumer protection provisions that discriminate against the banks are illegitimate.

Second: H.R. 10 should clarify that opinions of State insurance regulators are entitled to equal consideration in court reviews of State insurance laws. Section 306 creates a special procedure, for court procedures challenging State insurance regulations and dictates that State insurance regulators and the OCC are entitled to equal consideration during that review.

However, Section 104(b)(3)(C) exempts laws in existence prior to September 1998 and thus no equal deference standard. This exemption places in jeopardy a number of existing State regulatory provisions, this, especially maddening to PIA and to the insurance community at large, because the OCC simply has no expertise in the regulation of insurance.

Finally, PIA believes that the current list of safe harbors included in H.R. 10 must be strengthened and at a minimum encompass the full range of safeguards included in the Illinois legislation. Consumer protection provisions are the essence of State insurance regulation, and we firmly believe that they need to be in place.

In conclusion, PIA no longer opposes Federal efforts to permit affiliations between banks and the insurance industry; in fact, PIA and its members now embrace the prospect of viable financial services reform so long as the pertinent regulatory concerns are addressed lest consumers suffer. This means that a level playing field must exist for all of those who buy and sell insurance; particularly for PIA this means functional State regulation by State insurance departments charged with the task for almost two centuries. This should be for everyone who sells insurance, whether they do so from a professional insurance agent's office, a bank lobby or elsewhere.

PIA thanks the committee and, in particular, Chairman Leach and Ranking Member LaFalce for permitting us to offer our views. We look forward to working with you on financial reform. Thank you.

[The prepared statement of David O. Creighton Sr. can be found on page 453 in the appendix.]

Chairman LEACH. Thank you, Mr. Creighton.

Mr. Menefee.

STATEMENT OF W. NEAL MENEFEE, PRESIDENT AND CEO, ROCKINGHAM MUTUAL INSURANCE GROUP, ON BEHALF OF THE NATIONAL ASSOCIATION OF MUTUAL INSURANCE COMPANIES

Mr. MENEFEE. Good afternoon. My name is Neal Menefee. I am President and CEO of Rockingham Mutual Insurance Company. I am testifying today as Chairman of the Legislative Steering Committee of the National Association of Mutual Insurance Companies, NAMIC. NAMIC represents more than 1,200 property and casualty insurance companies, and the vast majority of them are organized in the mutual form.

The most important message I can deliver to you today is that the current state of laws governing the financial services industry is unacceptable. Most insurance companies cannot effectively compete and serve the needs of current and potential customers unless Federal laws are changed, and soon.

For instance, the company I manage cannot affiliate with a commercial bank situated in the Shenandoah Valley of Virginia, just a short distance from our offices. Even if there were a possibility of approval, we couldn't afford the legal and regulatory gymnastics necessary to get there under current law.

I would like to focus my testimony today on two aspects of H.R. 10, the expedited and equalized dispute resolution mechanism in Section 306 and the mutual redomestication provisions found in Subtitle B of Title III. Both provisions are important to NAMIC members. And I am proud to say that NAMIC was instrumental in conceiving and promoting the dispute resolution mechanism, a linchpin of H.R. 10.

First, some history: Faced with repeated Comptroller-led forays into their business by banks, insurance agents sought relief from the courts in the 1980's and 1990's. Relief was not to be found. The courts consistently ruled in the OCC's favor, invoking the Chevron doctrine which states that if a statute is silent or ambiguous with respect to a specific issue, the court should defer to a reasonable interpretation of the statute by the agency that has the duty to administer it.

Section 306 allows conflicts between State insurance regulators and Federal banking regulators about the definition of banking and insurance products, and the extent of preemption of State insurance laws or regulations to be litigated expeditiously and without an equal deference to either regulator. In other words, Section 306 instructs courts to promptly review cases and rule on the merits, not the territorial interests of a particular regulator.

This section distressed the OCC greatly last year and they may continue to oppose it. You should not be moved by their pleas. In the future, questions subject to the dispute resolution mechanism will involve conflicts between Federal and State regulators over the definition and conduct of insurance products and activities, and because the McCarran-Ferguson Act leaves the States as the primary regulators of insurance, it is reasonable and fair to require courts to show equal deference to a State insurance regulator and a Federal banking regulator.

The need for an expedited and fair dispute resolution is obvious and retaining Section 306 is critical to our support of H.R. 10.

As you know, capital is the lifeblood of financial services organizations. In the case of mutual insurance companies, however, options for raising additional capital are somewhat limited. That is why NAMIC members also strongly support the sections of the bill that address redomestication of mutual insurers. About 21 States have passed laws permitting their mutual insurance companies to convert into a mutual holding company structure.

To take advantage of the new affiliations and powers granted by H.R. 10, an entity must be in a holding company structure. However, as noted above, not all States have passed the legislation necessary to allow mutuals to establish holding companies. This means, even with H.R. 10, mutual companies could be at a significant competitive disadvantage.

Subtitle B of Title III permits a mutual insurer located in a State that has not yet approved mutual holding company legislation to transfer its domicile to a State that has. In order to use the Fed-

eral redomestication provision, the mutual's plan of reorganization must meet specified procedural and substantive requirements.

Some have argued it is inconsistent for the insurance industry to both support the redomestication provisions of H.R. 10 and insist on maintaining State regulation of insurance. We disagree. Since H.R. 10 mandates a holding company structure for these activities and affiliations, Congress must recognize that mutual insurance companies will be disadvantaged if they are located in a State that does not yet permit such holding companies.

H.R. 10 does not require States to allow mutual holding companies, nor does it create a Federal mutual holding company law. It merely allows insurance companies to move freely and without negative consequences into a State that allows them to create a holding company in order to enjoy the affiliations and powers granted under H.R. 10.

We believe the redomestication provisions are forward looking, consistent with functional regulation, and necessary to fully equalize the implementation of this historic legislation.

Though debates on financial services are often characterized as one segment of the industry versus another, it is important to recognize that with H.R. 10, the real winners at the end of the legislative process will be the American people. Financial modernization will enable consumers to access the entire range of financial products and services through whatever trusted source they may choose—a commercial bank, a securities firm, a life insurance company or their mutual property/casualty insurer. At the same time, these service providers will be free to compete vigorously to the benefit of the consumer with no individual segment enjoying an unfair advantage over any other.

By allowing financial services companies to compete equally in a regulatory structure that is sound, H.R. 10 will allow NAMIC members and their fellow insurance companies to better meet the current and the future needs of consumers.

Thank you.

[The prepared statement of W. Neal Menefee can be found on page 465 in the appendix.]

Chairman LEACH. Thank you. Thank you very much, Mr. Menefee.

Let me just begin with an IQ test. This town is filled with extraordinarily bright lawyers and people. But I would like to ask, Mr. Creighton, if you were asked the question what State in America provides the best law for a company to create an underwriting and insurance function, what State would you suspect that would be?

Mr. CREIGHTON. Mr. Chairman, I would say that the great State of Iowa offers that opportunity.

Chairman LEACH. I appreciate that. Let me just ask this question—particularly, Mr. Greenwood: There are a lot of ways of crafting laws of this nature, and there is a way that sounds like common sense. Someone says, I think we need a little narrower bill, and yet when you look at the narrow bill concept, there are some things that sometimes get left out, such as functional regulation.

Would it be fair to say, from an insurance perspective, that it would be a mistake to try to get too narrow and that what you need is a comprehensive approach such as contained in the current version of H.R. 10? Is that a fair description, or would that be a mistake?

Mr. GREENWOOD. I think it would be a fair description, Mr. Chairman.

I think the important thing is, you keep in mind the consumer as well as the change, and the *Barnett* decision and what that meant to us. I think what agents are asking for is clarity on this, for Congress to act on the term "significant interference," because that seems to be the most basic common threat of what I have heard here today. The country needs leadership on that. And I think we look to you for that.

Chairman LEACH. OK. Well, I appreciate that. I also appreciate that the landscape of finance changes very rapidly and philosophical perspectives get immensely shaped by the landscape. And I recognize probably as much as any, although a lot of people share this, that the industry communities had certain doubts about bank modernization over time.

And yet at this point in time, despite some fairly deep reservations and some preferred models, there appears to be a degree of consensus to move forward as long as things are, relatively speaking, balanced.

Is that a fair description from the majority of this panel?

Mr. GREENWOOD. No question, balance is the key to that. You have heard about a level playing field today, and you have heard the other things. And we have to say to you that the insurance industry recognizes that we are moving into a changing world. At the same time, it takes time for both the regulatory process and for the agent and company process to change to where the consumer is not hurt or damaged.

So I would say a common-sense approach to orderly moving into this direction is something that is going to benefit all of us. And certainly I think the key here, though, is—when you talk about functional regulation is that there truly be a clear understanding about all of the players as to how this is going to play out in the future, or we are going to spend millions and millions of dollars in litigation fees trying to define these questions.

Chairman LEACH. Well, you raised an important issue. I mean, the more one can be definitive in terms of framework, the more one can avoid conflicts in the future. And I think that is something that all sides have an extraordinary vested interest in doing.

Mr. GREENWOOD. Certainly you know the history, and in the last session and this year, as we have worked with the Bankers Association, we have recognized that there must be compromise and more unity in these areas. At the same time, there are some basic principles that we stand for, like the State regulation of insurance, but we have also compromised on many of the other topics here.

Chairman LEACH. Thank you.

Mr. Watt.

Mr. WATT. Thank you, Mr. Chairman.

Mr. Greenwood and Mr. Creighton, I want to direct my questions primarily to the two of you, because it sounds like everybody else

is kind of on board here. And I want to be clear on where you all are.

I have not heard from my Independent Agents this term of Congress, and maybe that is a sign that they are exactly satisfied. But do I understand that the two of you are representing the Independent Agents and that despite the fact that you had some three or four different concerns about this bill, if those concerns were—obviously, if those concerns were addressed, I take it you would be supportive of H.R. 10 as introduced?

Mr. GREENWOOD. No question, if those concerns were addressed——

Mr. WATT. Whether you get it or not?

Mr. GREENWOOD. Let me just state, I don't want to speak for my friend from PIA. I am here representing the Independent Insurance Agents of America, together with the National Life Underwriters, and we, like in the Senate portion we negotiated with the bankers, remain silent on our support of this. We think there are some concerns here that need to be addressed, and rather than jump out and say, "Yeah, we are going to support this, we feel a bill is needed."

We need to move orderly in the direction of getting a bill. But at the same time, you haven't heard from your Independent Agent, because no one has advised him or her as to what our position is.

Mr. WATT. Well, that is true. I mean, that doesn't always stop them from calling me and expressing their opinions though.

Mr. GREENWOOD. That is what makes him independent, and we love it.

Mr. WATT. I have had two different ones on the same street call me and give me two different opinions sometimes.

Mr. GREENWOOD. Again, we are independent.

Mr. WATT. Mr. Creighton, do you want to respond? Assume the four items that you addressed that need to be changed didn't get changed; would you be supportive of the bill, as it is currently introduced?

Mr. CREIGHTON. I think that we would probably gravitate toward—probably toward prochoice, as the Congressman said.

Mr. WATT. I am sorry. Say again.

Mr. CREIGHTON. I think we would gravitate——

Mr. WATT. Are we talking about abortion or insurance here?

Mr. CREIGHTON. Congressman LaFalce——

Chairman LEACH. If the gentleman would yield, we had some earlier discussion.

Mr. WATT. I missed that part.

Chairman LEACH. Some of these discussions have involved choice, some others, a proprudence perspective.

Mr. WATT. OK. I missed that discussion. I am sorry.

Mr. CREIGHTON. I am sorry, Mr. Congressman. Assuming those four items were addressed, we would move toward favoring that bill, yes. We are neutral at this moment, similar to what AIA said.

Mr. WATT. All right. I take it there is nobody at this table who has a particular dog in the fight about whether you do this as a holding company or as an op sub? That is kind of more a banking, big guys issue than it is in insurance?

Mr. POPE. That is a big insurance issue.

Mr. WATT. Let me hear your opinion on that then.

Mr. POPE. The American Council of Life Insurance strongly opposes the op sub provision in H.R. 10. We do not support the bill if it were in.

Mr. WATT. Beg your pardon?

Mr. POPE. We not support the bill if it was in.

Mr. WATT. That was the next question I was getting ready to ask you. It is one thing to strongly oppose, and it is another thing to oppose it and encourage people to vote against it. You would not go there?

Mr. POPE. We would—we could not support a bill that had an op sub provision in it.

Mr. WATT. Why is that?

Mr. POPE. Well, if we have a few moments, let me try and go back a little bit to the history of this. But in an op sub situation, most of the discussion heretofore has been about the bank and the bank level and is there a cost advantage to the bank to have an op sub organization versus a holding company situation.

I think more what is happening to the subsidiaries in that situation—let's take, for example, not that there is a subsidiary that becomes financially distressed, but let's say the bank at the top becomes financially distressed, and in that situation the banking regulator has certain options available to him or her, such as prompt corrective action, such as least-cost resolution provisions, which dictate that that regulator make that bank well by pulling funds up from the subsidiaries back to the bank to fully capitalize the bank.

Now, when that occurs, a subsidiary could very well become ill, and the insurance regulators' protests to stop that kind of a withdrawal of funds from the sub back to the bank level would be unheeded because prompt, corrective action—certainly, I believe the least-cost resolution provisions supersede any type of an insurance commissioner's protest to the contrary.

In the affiliate structure, separately capitalized affiliates, the Fed, as the umbrella regulator of the financial services holding company, does not have the authority to pull funds to dividend funds up from one affiliate through the holding company and back to another affiliate that may be ill; they can require divestment, but they can't require one separately capitalized affiliate to get into a financially distressed situation.

Mr. WATT. So are you assuming always that the parent of the op sub is always going to be a bank?

Mr. POPE. Yes, sir.

Mr. WATT. OK. So you don't conceive that it would be an insurance company then?

Mr. POPE. I don't think that any op sub provision that I have seen provides for the insurance company at the holding—or at that level. I believe it is a bank with operating subsidiaries under it. That is the way I have always seen it written.

Mr. WATT. OK. All right. I am learning.

Thank you, Mr. Chairman. I yield back the balance of my time.

Chairman LEACH. Thank you.

Well, Mr. Greenwood comes with two hats as being an independent banker and independent insurance agent.

Our next member of the panel comes with at least two hats as being an independent Member of Congress and former head of one of the most innovative insurance companies in the country; and so, as our expert on insurance, Mr. Hill, would you proceed?

Mr. HILL. Well, thank you, Mr. Chairman. Let me just stay on this question Mr. Watt asked, because, Mr. Pope, you are the only one that answered that question. And incidentally, I agree with your position.

But, Mr. Rhulen, do your folks have a position with regard to the op sub question?

Mr. RHULEN. I would say that we would support H.R. 10 regardless of the decision that was made on op subs.

I would also like to point out—and correct me if I am wrong—that if the equitable resolution standards and procedures which were put—which are supposed to be put in place as part of H.R. 10 were in fact enacted, the insurance regulators would have the power to prevent upstreaming of money from an insurance company in the same way that they have that power now to prohibit me from upstreaming money from my insurance companies' subsidiaries to the parent holding company.

So those protections already exist today in the insurance environment. And I don't know why they wouldn't continue to exist as long as the State insurance regulators were given the power to combat the Federal regulators on the banking side.

Mr. HILL. Obviously, the other side of that question is whether or not it operated as a subsidiary, there is a migration of subsidy, as well, in terms of capital and other sets of issues.

I guess I would ask you, Mr. Menefee, do you folks have any view on the issue of op subs?

Mr. MENEFEE. Yes, sir, our position would be similar to the two gentlemen ahead of me. We would be concerned about operating subs, particularly to the degree that it allowed insurance underwriting.

Mr. HILL. All right. The issue is risk-taking. H.R. 10 allows operating subsidiaries for sales purposes. While we are on that subject——

Mr. WATT. Would the gentleman yield for half a second, because I have been told that the bill that Mr. LaFalce was contemplating would not allow insurance underwriting in the op sub. Do you all understand that to be the case?

Mr. MENEFEE. We have not——

Chairman LEACH. If the gentleman would yield, that is my understanding, that it would not allow either real estate development or insurance underwriting, but would largely allow merchant banking; and that is the major differentiation from the bill that came out of the committee last year.

Mr. WATT. Would the gentleman continue to yield? Just allow me to ask Mr. Pope whether that changes his opinion.

Mr. HILL. So long as you ask consent to give me more time.

Mr. WATT. I just want, with that clarification, whether Mr. Pope—whether that would have any bearing on Mr. Pope's statements earlier.

Mr. POPE. Congressman, I can't speak for the securities industry. And I think that that is what the LaFalce bill would do is to allow

op subs for securities, but not for insurance. If that is the situation, I think—you know, we need to see what the language is, but we can certainly work with it.

Mr. WATT. Thank you. Thank you. And I ask unanimous consent that Mr. Hill be given two additional minutes.

Chairman LEACH. Without objection, that is agreed to. We have a rule here though that when there is a preeminence of intellect, extra time is allocated.

Mr. WATT. Under that theory, you can give him at least one additional minute.

Mr. HILL. Mr. Chairman, does the time taken for discussion of yielding count against the time that I would be yielding?

Just kidding. Thank you, Mr. Chairman.

I just want to quickly go on with that. Do any of you have a position with regard to the thrift charter question with regard to H.R. 10? Mr. Pope? Mr. Menefee? Mr. Rhulen? Do any of your associations have any position with regard to that? I don't think the agent groups do.

How about with respect to baskets allowing for commerce and banking. Mr. Pope, does your association have a position on that?

Mr. POPE. Congressman, the ACLI will support the bill either way when it comes to the basket. So I think——

Mr. HILL. Mr. Rhulen?

Mr. RHULEN. The AIA similarly will support the bill.

Mr. HILL. And Mr. Menefee?

Mr. MENEFEE. Yes, likewise.

Mr. HILL. Going back to—I made a point earlier about the public official and real positions. I think H.R. 10, as it now stands, is kind of boiled down to the real positions that everybody has. I mean, it seems to me that some groups are in the neutral position; other people are supporting it, however, would like to see changes; but it seems that there is a pretty delicate balance that has been accomplished here.

The concern I have is really with regard to the matter of functional regulation with regard to the issue of solvency more than anything. I think the sales issue is pretty well worked out here. I mean, I think that there are some concerns and, Mr. Creighton, I agree with some of them that you have raised. But the real question here is whether or not we are going to be interfering with the solvency of the insurance industry by these new financial institutions, the restrictions on State regulation.

Mr. Pope, you made one really good recommendation, I think, and if you have some more that you want to provide, I would appreciate your contacting our office, because I think you are right about that. I think there has to be deference to the State regulators with regard to those matters.

If there are others, I would just ask, if I could, if any of you have any other specific to that matter of solvency that you think ought to be incorporated into H.R. 10 that is not there now?

Let me start with you, Mr. Menefee.

Mr. MENEFEE. No, sir, I don't know that I have any specific recommendation, although I think our feeling is that we need H.R. 10 in order to address the rapidly evolving issues so we do maintain

the solvency of the industry. We feel like perhaps without H.R. 10, or some form thereof, then that is very questionable going forward.

Mr. HILL. Mr. Greenwood.

Mr. GREENWOOD. No comment.

Mr. POPE. Congressman, let me just expand for a few minutes on what I said in my testimony; and this is an issue that kind of came to me a little late in the game, and perhaps since I was a little dense and didn't quite understand what the NAIC was trying to get to when it came to the authority of the Federal—of the Federal Reserve Board when it comes to the affiliation of an insurance company by a bank, what I think comes from all three years of studying this bill, but what I think bothers me the most is that the Federal Reserve, for all of its power and all of its intelligence and certainly the way it has run the economy—it is a tremendous organization—for all of that power and all of that intelligence, I don't believe it has any experience whatsoever with regard to managing an insurance company.

That expertise lies in the 50 State insurance commissioners. That is why each and every State has passed a law that says, before you allow an insurance company to be taken over, you have to go before a State insurance commissioner, present your case, stand up before a hearing, and that commissioner has to make specific findings of fact and conclusions of law that dictate that it is in the best interests not of the companies involved, but it is in the best interests of the policyholders that that merger or that acquisition take place.

What bothers me about H.R. 10, as it currently stands, is the Fed is allowed in the mega-merger, the $40 billion and above situation, to make that determination, but it has no ground rules. It has no framework from which to determine how one finds out what is in the best interests of the policyholders. And that is different from being in the best interests of a depositor or the best interests of a holder of a security.

So in my opinion, the language that we have put in my testimony helps provide the Fed with some solid groundwork, some solid guidelines with which to make that determination. We think it is pretty important.

Mr. RHULEN. Every State has an insurance guaranty fund that protects the policyholders on admitted policies written in that State. As long as H.R. 10 contains language which defines insurance and provides an equal playing field for the Federal and State regulators, the protection of solvency of the insurance companies should be pretty much assured through that process, as long as the Federal regulators are not allowed to invade the policyholder funds of the insurance companies.

Mr. CREIGHTON. We don't have any real comment on this.

Mr. GREENWOOD. Let me just follow up, Congressman, in saying that the one thing I think that I recognize in being both, in the past 20 years, regulated by the Comptroller through banking and by the State insurance department in Kentucky is the difference in territorial regulation. The fact that the insurance product and the local situation—whether it be the difference in Montana or in Florida, or the difference in the marketplace, experienced elected regulators versus appointed regulators—on and on and on—is that the

consumer is best protected when the regulation is at the local level. And I think that is the thing that, as we talk, whether it be about solvency or the consumer protections, that we want to protect the State's ability to know what is happening in that State. And many times, particularly with smaller, regional companies, it might be knowledge that something as far as the solvency of an insurance company is in jeopardy or whatever by their behavior.

It is going to be an extremely difficult product to regulate any way other than at the closest-to-the-consumer level, and that is why we stand so firmly behind State regulation.

Mr. HILL. I thank all the members of the panel for their great input.

Thank you, Mr. Chairman.

Chairman LEACH. Thank you, Mr. Hill.

Mr. Sweeney. Excuse me, Mr. Sweeney; I am sorry. There is a Democrat present.

Mrs. Jones.

Mrs. JONES. Hear, hear for the Democrats, concerned about banking as well. A couple of questions. Thank you, Mr. Chairman.

I think you are Mr. Rhulen, right?

Mr. RHULEN. Yes.

Mrs. JONES. You said that you had no problem as long as the Federal regulator was not permitted to invade—finish that.

Mr. RHULEN. The policyholder funds of the insurance company.

Mrs. JONES. So, in other words, if the State had a fund that protected—that was supposed to pay off policyholders, and it ran out of money, just for example, and there was some suit against your company—I mean, I don't think that is going to happen now—but you are saying that you would be supportive of this only if he didn't have to pay out of your individual funds and the dollars solely came out of this fund that the State held of policyholders, right?

Mr. RHULEN. No, no. Two issues. The insurance company has surplus which is there to protect interests of the policyholders directly. If there ever was an insolvency of an insurance company where that surplus has been completely diminished, the State steps into the shoes of the insurer and therefore provides that protection to the policyholder.

What you wouldn't want to allow is the Federal banking regulators to get at the surplus of the insurance company, thereby putting them in an insolvent position, where previously they were not.

There are risk-based capital standards for insurance companies where you could easily put an insurance company into an insurance department control situation by virtue of taking enough surplus out of the insurance company without actually putting it into bankruptcy.

Mrs. JONES. I wanted to be clear on what your response was. Thank you very much.

Based on H.R. 10, though, I have heard from the bankers and the savings and loans and now the insurance companies—independent, as well as agents, as well as companies. Are there more bankers likely to sell insurance, or are there more insurance persons than ever thinking about going into banking? We can start at the far end.

Mr. MENEFEE. Congresswoman, I am not sure I hazard an answer to that question. I think we——

Mrs. JONES. What do you think?

Mr. MENEFEE. We all appreciate there is convergence of financial services to the degree I think that consumers are looking more and more for a combination of products. So I think you would certainly see some of both. To say that there would be more bankers selling insurance than there would be insurance companies or agents offering banking products, I don't know that I would try to draw that line, but——

Mrs. JONES. Are you thinking about becoming a banker if H.R. 10 passes?

Mr. MENEFEE. We are paying close attention to what our customers are looking for and working to be responsive in that regard; and I would say, as I heard several comments early this morning, that the advantages of an electronic commerce world makes some of the things more available to small and medium-sized companies like ours than we have had in the past.

So, yes, we are looking at what our customers tell us they want, yes, ma'am.

Mr. GREENWOOD. Well, certainly as the agents association, we recognize that financial modernization and financial services are going to merge in the future. We have already applied for a thrift charter. I can tell you that I have some reservations, I guess, with what an individual can actually keep up with in this new, emerging area, as to whether or not they can be specialists in securities and in financial institutions and in insurance.

I do think technology is going to drive integration, but at the same time agents across this country know that their relationship with the customer is the thing that gives them value.

Mrs. JONES. Since I am running out of time, I don't want the rest of you to answer that question.

I want to ask you another question, Mr. Rhulen.

Mr. RHULEN. Yes, ma'am.

Mrs. JONES. I am looking at your testimony on page 4. Let me give you a little quick background where I come from. I am a former district attorney for eight years, a judge for ten years before that.

You are going to rely upon a court for an expedited hearing in order to agree to H.R. 10? That is what you are telling me?

Mr. RHULEN. It is in the bill. I guess that is the only language that I could rely on.

Similarly, I also am an attorney, and in an order to show cause, we often get expedited proceedings. I guess we would look for that same type of treatment in this situation, especially where it could imperil the safety of one of our insurance companies or our banks.

Mrs. JONES. So you are looking for equity status?

Mr. RHULEN. Absolutely.

Mr. POPE. Mrs. Jones, I believe that what the expedited dispute resolution process provides for is, it skips the district level of the court. The dispute between the regulators would begin at the court of appeals level and then move to the Supreme Court.

Mrs. JONES. The circuit court.

Mr. POPE. You would save one level. It is expedited a little better than it would be then, starting at the Federal district court level.

Mrs. JONES. Let me continue down this trail a little bit—or this path, excuse me.

With regard to what the Federal court must consider, a regulator must consider that the Fed must solicit views on the affiliations, looking at the State regulators' opinions; and then it goes on to say on the next page, or the page before, that the regulator shall—even though "must" and "shall" is the language used, we all recognize that after that, it becomes I "must" consider, it still is left to my discretion as a hearing officer or as a judge to make a determination.

You all are comfortable with that language?

Mr. POPE. I would rather have it the other way, where the insurance commissioner makes the determination, but I am not going to get that. In this situation, we will rely on the Fed's best judgment. But the language that I have in my testimony gives the Fed some guidelines that we didn't have before, quite frankly.

Mrs. JONES. Thank you.

Mr. Kilbride—Mr. Chairman, may I have a couple more minutes?

Chairman LEACH. Absolutely, absolutely.

Mrs. JONES. Mr. Kilbride, in your testimony you were talking about NARAB and that in a State—if the State couldn't agree to the licensing of an insurance person after two years, then NARAB would come into place.

Why are you much more comfortable allowing a regulate—I hate to call it a "regulation," but a Federal grouping to authorize agents across the board and not a Federal grouping to license insurance companies? Am I clear?

Mr. KILBRIDE. Not totally.

Mrs. JONES. Do you want me to try it again?

Mr. KILBRIDE. Please.

Mrs. JONES. OK. Currently each State licenses insurance agents, right?

Mr. KILBRIDE. Yes.

Mrs. JONES. You are saying to me that in order to improve the financial or economic opportunities in this country, you would suggest that in order for us to operate interstate, or agents to operate interstate, if a particular State could not come up to or resolve licensing of a particular agent within a two-year period, then this group called NARAB would do that, is that correct, authorize that person to operate outside the State in which he or she was licensed? Am I correct?

Mr. KILBRIDE. No, I don't think it is quite correct.

First of all, the period is three years, before the creation of NARAB, which would be run by State insurance commissioners, and they would be on the board. They would have the chairmanship of that board, and they would continue to——

Mrs. JONES. But they would oversee the entire country, correct?

Mr. KILBRIDE. They would oversee their States.

What we are trying to do here is get uniformity in licensing to make it easier for agents to get licensed from State to State. We are not trying to have them get Federal regulation here.

Mrs. JONES. You are going to put it differently than I am. In essence, though, you are saying that this group would allow someone to operate interstate as a licensed agent, correct? NARAB would be the authorizing agent?

Mr. KILBRIDE. It would facilitate the ability of an agent to operate from State to State.

Mrs. JONES. You are playing with my words.

Mr. KILBRIDE. No, I am not trying to.

Mrs. JONES. Yes, you are. But what I am suggesting is, if in fact a group of people could get together to authorize an agent to operate interstate, why is it not conceivable that a group of people could get together to authorize regulating insurance interstate?

Mr. KILBRIDE. I think it is conceivable.

Mrs. JONES. But it is not proposed in this bill?

Mr. KILBRIDE. It is not proposed in this bill because we have enough opposition from the NAIC to NARAB.

What we are trying to do is put in a provision that will allow them to support our position as opposed to further take issue with it.

Mr. RHULEN. If I may, just for a moment, keep in mind also you have got 50 States where any individual insurance company that is licensed—that is domiciled in a particular State, that State insurance commissioner is responsible for the guaranty fund that supports that company. They are not likely to want to let someone else have control over that insurance company when the policyholder and the citizens of their State are really the ones responsible.

Mrs. JONES. I wasn't contemplating that in my discussion. What I was contemplating in my discussion is, if you are going to go interstate, or interstate in licensing insurance agents, why wouldn't you be willing to go full ream and go interstate in licensing insurance companies per se?

My last—no more questions for you.

Mr. Chairman, the only question I want to say is, according to my assistants, Delaware is supposedly the State where getting insurance is supposed to be the best in the land.

Chairman LEACH. Well, you have second-best information, but I am——

Mrs. JONES. It came from some book.

Chairman LEACH. I would say to the gentlelady, if there is any unstated consensus in this room, it is the following. If any of these people are operating a financial institution and if any of them were to ask who they met in the last six months that they would like to sell their products, I think the name Mrs. Jones would come out number one.

Mr. Sweeney, we will go to you—if you have a further question, we will go to another round. Mr. Sweeney.

Mr. SWEENEY. Thank you, Mr. Chairman. Maybe let me ask this question that my good friend was asking, but from the other side, to Jim Kilbride.

How do we assure those who worry that a uniform licensing process is not an infringement on States' rights and how do we assure those people that by doing so, by creating this system, that we are not going to displace any uniform licensing regime or any State law

that governs? How do we answer that question when we are asked that?

Mr. KILBRIDE. I think we answer it by saying that, first of all, our provision gives the regulation to State insurance commissioners and superintendents. They are the ones who will run NARAB. They are the ones that still will have the jurisdiction over all the agents that are licensed in their State, both resident and non-resident.

So it is something that they run; we have given them that authority in this provision. There should be no reason why they are reluctant to pick up that authority. They certainly aren't now.

Mr. SWEENEY. And what standards would be applied to ensure that State law is not preempted in any regard? I mean, what protections are provided to ensure that?

Mr. KILBRIDE. The same ones that are existing now.

Mr. SWEENEY. OK.

Mr. KILBRIDE. What we are trying to do is make it easier to get agents licensed from State to State, an easier process with some uniformity. It is a simple as that.

Mr. SWEENEY. OK. And I only have one other question, and it really is a follow-up on a question I asked Michael Smith in the prior panel. And it is to Bill Greenwood.

In your testimony, you stressed the need to clarify preemption standards with respect to restrictive State regulations. Could you characterize for me the degree to which State laws may be preempted under the current language?

Mr. GREENWOOD. Let me just say when we mentioned that maybe 25 to 30 States out there that already have enacted consumer protections for banks' sales of insurance, and we looked at the strength of each of those, the stronger States with more consumer protection, I would say, are from Rhode Island to Illinois, Florida, West Virginia, those types of laws.

The way that safe harbor provisions are in this H.R. 10 language, many of those would actually be weakened because there is the very process of a separate office for the sales of insurance, for instance, it is not a part of safe harbor, but on the other hand, and in many of these States that is of concern that the consumer be protected against intimidation or coercion. So I think that when we talk about State regulation, the ability of a State to regulate its banking and insurance environment, they are closer to the local level.

Mr. SWEENEY. I happen to agree very strongly with you.

I yield the rest of my time, Mr. Chairman.

Chairman LEACH. Thank you, Mr. Greenwood.

Mrs. Jones, do you have another question?

Mrs. JONES. You mean I get to ask another question?

Chairman LEACH. If you would like.

Mrs. JONES. I did have one more question. Thank you, Mr. Chairman. To each of you insurance agents who plan to, or insurance corporations that intend to become banks, you will abide by the Community Reinvestment Act and be prepared to go back to the community to provide them what they need under the law, correct?

Mr. RHULEN. No question.

Mrs. JONES. Excuse me, all right. I want to be clear now. I am good at cross-examination.

Thanks, Mr. Chairman, I appreciate it.

Chairman LEACH. It is your intention to abide by the law; is that correct?

Well, let me thank you all. And I think this has been a very, very helpful panel, and I am very appreciative of the perspectives that have been presented.

This brings today's hearing to an end. The hearing is adjourned.

[Whereupon, at 5:20 p.m., the hearing was adjourned.]

H.R. 10—THE FINANCIAL SERVICES MODERNIZATION ACT OF 1999

THURSDAY, FEBRUARY 11, 1999

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON BANKING AND FINANCIAL SERVICES,
Washington, DC.

The committee met, pursuant to notice, at 10:08 a.m., in room 2128, Rayburn House Office Building, Hon. James A. Leach, [chairman of the committee], presiding.

Present: Chairman Leach; Representatives McCollum, Roukema, Bereuter, Baker, Bachus, Castle, Lucas, Kelly, Paul, Ryun, Cook, Riley, Hill, Manzullo, Ryan, Ose, Biggert, Sweeney, Terry, Green, Toomey, LaFalce, Vento, Kanjorski, Sanders, Watt, Bentsen, J. Maloney of Connecticut, Hooley, Weygand, Sherman, Meeks, Mascara, Inslee, Schakowsky, Moore, Gonzalez, Jones, and Capuano.

Chairman LEACH. The hearing will come to order.

During our opening hearing, we heard from a number of parts of the financial services industry, and pretty solid support was voiced for banking modernization. And, in addition, we heard from other parties that have indicated very constructive alternatives that may be part of the consideration process.

Today, we're going to hear from the distinguished Chairman of the Federal Reserve Board, as well as from a panel of State financial service regulators and a group of consumer representatives.

We're honored to begin with Mr. Greenspan, and I would ask the panel's deference in one circumstance. The Chairman has just returned from an overseas trip, and I think if he's like me, is suffering from a bit of jet lag. And so we hope we won't keep you too long, Mr. Chairman.

Mr. GREENSPAN. I'm worried I'll be inordinately clear as a consequence.

[Laughter.]

Chairman LEACH. Well, the perspective of 36,000 feet is sometimes better than the perspective of those of us that are earthbound. In any regard, we're honored you're with us. And please proceed. Without objection, a full statement will be placed in the record, and you may summarize or read as you see fit. Mr. Chairman.

STATEMENT OF HON. ALAN GREENSPAN, CHAIRMAN, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM

Mr. GREENSPAN. Thank you very much, Mr. Chairman. It's a pleasure, as always, to appear before this committee, especially to

present the views of the Federal Reserve on the need for legislation to modernize the U.S. financial system, because this is an issue which, as you are aware, we have talked about to a great extent, and the reason we have is that it is a very important issue confronting this Nation.

The Federal Reserve continues to support strongly the enactment of such legislation and believes that H.R. 10 contains the fundamental principles that should be included in such legislation. I commend the committee for taking up this vital matter so promptly in this session.

U.S. financial institutions are today among the most innovative and efficient providers of financial services in the world. They compete, however, in a marketplace that is undergoing major and fundamental change driven by a revolution in technology, by dramatic innovations in the capital markets, and by globalization of the financial markets and the financial services industry.

For these reasons, we support removal of the legislative barriers against the integration of banking insurance, and securities activities. There is virtual unanimity among all concerned, private and public alike, that these barriers should be removed. Technologically driven proliferation of new financial products that enable risk unbundling have been increasingly combining the characteristics of banking, insurance, and securities products into single financial instruments. These changes, which are occurring all over the world, have also dramatically altered the way financial services providers operate and the way they deliver their products.

In the United States, our financial institutions have been required to take elaborate steps to develop and deliver new financial products and services in a manner that is consistent with our outdated laws. The costs of these efforts are becoming increasingly burdensome and serve no useful public purpose. Unless soon repealed, the archaic statutory barriers to efficiency could undermine the global dominance of American finance, as well as the continued competitiveness of our financial institutions and their ability to innovate and to provide the best and broadest possible services to U.S. consumers.

We believe that it is important that the rules of our financial services industry be set by the Congress rather than, as too often has been the case, by banking regulators dealing with our outdated laws. Only Congress has the ability to fashion rules that are comprehensive and equitable to all participants and that guard the public interest.

The market will continue to force change whether or not Congress acts. Ad hoc administrative responses to these market forces lead to inefficiencies and inconsistencies, expansion of the Federal safety net, potentially increased risk exposure to the Federal deposit insurance funds, and a system that will undermine the competitiveness and innovative edge of major segments of our financial services industry.

H.R. 10 also recognizes another dimension of the changing nature of banking and financial markets: that financial modernization means more than authorizing new powers and affiliations. Not only are we experiencing a revolution in financial products and their delivery, the U.S. is also at a historic crossroads in financial services

regulation. It is becoming increasingly evident that the dramatic advances in computer and telecommunications technologies of the past decade have so significantly altered the structure of domestic, indeed, global finance as to render our existing modes of supervision and regulation of financial institutions increasingly obsolescent.

The volume, sophistication, and rapidity of financial dealings will inevitably lead to supervisory emphasis on oversight of risk management of financial institutions and a marked scaling back of outmoded loan file and balance sheet surveillance. Moreover, affiliation with banks need not, indeed, should not, create bank-like regulation of affiliates of banks.

This shift in supervisory mode, which is already underway, is market driven. It is not the result of some potentially reversible ideology. Such an approach is captured in H.R. 10 in many of the so-called "Fed-light" provisions, and we at the Fed strongly support this approach.

H.R. 10 also, in our judgment, has chosen the appropriate structure to combine banking, securities, and insurance firms using financial service holding companies. While we enthusiastically support the new powers granted to financial service holding companies, we just as strongly believe that they should be financed by the marketplace, not by instruments backed by the sovereign credit of the United States. The requirement that the new powers be conducted through holding company affiliates minimizes the expansion of the use of the subsidies arising from a safety net backed by the U.S. taxpayer.

The rejection of expanded powers for subsidiaries of commercial banks, at least those conducted as principal, is a decision that will inhibit the widespread employment of Federal subsidies over a new range of activities. These activities, if conducted in bank subsidiaries, would accord banking organizations an unfair competitive advantage over comparable insurance and securities firms operating independently or as bank holding company subsidiaries. By fostering a level playing field within the financial services industry, we contribute to full, open, and fair competition as we enter the next century.

Even more important, to inject the substantial new subsidies that would accrue to operating subsidiaries of banks into the currently mushrooming domestic and international financial system could distort capital markets and the efficient allocation of both financial and real resources that have been so central to America's current prosperity. The choice of requiring the new powers to be harbored in affiliates of holding companies, not in so-called op-subs of their banks, will significantly fashion the underlying structure of 21st Century finance.

This choice of the holding company structure is also critical to the way in which financial services industry will develop because it provides better protection for and promotes the safety, soundness, and stability of our banking and financial system without damaging the national or State bank charters or limiting in any way the benefits of financial modernization. The other route toward full powered commercial bank operating subsidiaries and universal banking would, in our judgment, lead to greater risks for the de-

posit insurance funds and the taxpayer. It is for these reasons that the Federal Reserve, Securities and Exchange Commission, many State functional regulators, and many in the affected industries have supported the holding company framework and have opposed the universal bank approach.

Another 21st Century issue is whether we should move beyond affiliations among financial service providers and allow the full integration of banking and commerce. As technology increasingly blurs the distinction among various financial products, it is already beginning to blur the distinctions between predominately commercial and banking firms. But how the underlying subsidies of deposit insurance, discount window access, and guaranteed final settlement through Fedwire, are folded into a commercial firm, should the latter purchase a bank, is crucially important to the systemic stability of our financial system.

It seems to us wise to move first toward the integration of banking, insurance, and securities as envisaged in H.R. 10 and employ the lessons we learn from that important step before we consider whether and under what conditions it would be desirable to move to the second stage of full integration of commerce and banking. Nothing is lost, in my judgment, by making this a two stage process. Indeed, there is much to be gained. The Asian crisis last year highlighted some of the risks that can arise if relationships between banks and commercial firms are too close, and make caution at this stage prudent in our judgment. In line with these considerations, the Federal Reserve Board continues to support elimination of the unitary thrift loophole, which currently allows any type of commercial firm to control a federally-insured depository institution.

These principles, which we see as fundamental to financial modernization, are embodied in H.R. 10. As in all such major legislation, there are and will be numerous provisions only indirectly associated with the legislation's core principles that often foster disagreements. These surrounding details are doubtless important, but not so important that they should be allowed to defeat the consensus that has developed around the key principles embodied in H.R. 10. It would be a disservice to the public and the Nation if, in the fruitless search for a bill that pleases everybody in every detail, the benefits of this vital consensus are lost or further delayed.

In virtually every other industry, Congress would not be asked to address issues such as these, which are associated with technological and market developments; the market would force the necessary institutional adjustments. Arguably, this difference reflects the painful experience that has taught us that developments in our banking system can have profound effects on the stability of our whole economy, rather than the limited impact we perceive from difficulties in most other industries.

While financial modernization represents much needed reform, we should not forget that this modernization will, by itself, introduce dramatic changes in our financial services industry. We feel confident that the risks of this type of reform are manageable within the holding company framework set out in H.R. 10.

There is a final point I want to make since it appears to have driven Treasury's opposition to last year's version of H.R. 10. H.R.

10 would not diminish the ability of the Executive Branch to continue to play its meaningful role in the development of banking or economic policy. Currently, the Executive Branch influences such policy primarily through its supervision of national banks and Federal savings associations. H.R. 10 would not alter the Executive Branch's supervisory authority for national banks or Federal savings associations, nor would it result in any reduction in the predominate and growing share of this Nation's banking assets controlled by national banks and Federal savings associations. Indeed, as of September 1998, nearly 58 percent of all banking assets were under the supervision of the Comptroller of the Currency, up from 55.2 percent at the end of 1996.

Furthermore, Congress for sound public policy reasons, has purposefully apportioned responsibility for this Nation's financial institutions among the elected Executive Branch and the independent regulatory agencies. Action to alter this balance would be contrary to the deliberate steps that Congress has taken to ensure a proper balance in the regulation of this Nation's dual banking system.

Mr. Chairman, the markets are demanding that we change outdated statutory limitations that stand in the way of more efficiently and effectively delivering financial services to the public. The Federal Reserve agrees and urges prompt enactment of the Financial Modernization contained in H.R. 10.

Thank you very much.

[The prepared statement of Hon. Alan Greenspan can be found on page 481 in the appendix.]

Chairman LEACH. Well, thank you, Mr. Chairman, for your very thoughtful statement. I have just one observation and query that, as you know and partly as indicated by the testimony yesterday, there does appear to be greater consensus than has ever existed before within and between industrial groupings on bank modernization in terms of the construct.

There's a second issue, which relates to regulation and where the principal regulatory focus should be. You've given a very strong view of the Fed's perspective, one that I respect very much. You've also implied that the Treasury may differ. And so the question I have, and it was reflected yesterday by several of our witnesses, relates to the fact that while there does appear to be consensus on industrial construct, there is still some difference on regulatory division of authority. And so my query is to the degree those differences still are maintained between, particularly, but not exclusively the Fed and the Treasury, is the Federal Reserve open to discussing these issues with the Treasury with the prospect of perhaps coming forward with a common front or do you think that is a frail option and that the Congress will just have to make these decisions on our own recognizing that differences between the Fed and the Treasury will remain?

Mr. GREENSPAN. Well, Mr. Chairman, I think we have always been open to try to find a vehicle which will essentially satisfy Treasury. Let me try to indicate to you where the differences are and why they exist, and where the potential for a solution, in our judgment, lays. We both agree, apparently, that if new powers are put into the subsidiaries of the commercial banks, that it will be in the interests of the bank holding companies or banking organi-

zations, or anybody else for that matter, to move the powers into the subs of the banks. The reason I say that is that is not the case. If, for example, they're very rarely used, then the issue of additional powers going to the OCC would not exist.

It implies in their concern about increased powers that their view of what will happen if the Congress gives the powers to the operating subs is the same as ours. And our view is that the consequence of doing that is so thoroughly negative to the issue of the financial structure of both our domestic and international interfaces of American banking and finance, that that is much too high a price to pay for an issue, which in our judgment, probably could be resolved by different means. By that I mean, we fully support the view that the Administration and the Treasury, the Executive Branch, should have very significant powers in the area of policy and supervision on banking and finance. We believe they do that and, indeed, we even supported, as you well know, very strongly interstate banking. And we did so knowing full well that it would create an improved national charter vis-a-vis the State charter which is the base of where our supervision lays.

That's the reason, incidentally, why the share of assets under the OCC in the last couple of years, last three years I guess, two years, has risen from 55 to 58 percent. And, indeed, the banks have increased. In other words, there's been a very significant increase in the last couple of years, 1996? It's the end of 1996, it's really the end of 1996 and the end of 1998, there's been a very dramatic increase in the amount of assets and control under the OCC. And we think that's perfectly appropriate. We have no concern about that. We think that it was important that there be a substantial shift toward national banking and being able to branch across State borders; and we fully were aware that that would diminish the State charter in the process. We didn't particularly like that, but we thought the values were there so that the issue was not Federal Reserve turf.

We would like to find a way in which Treasury would feel satisfied that it had the types of controls that it thought were necessary. We are only concerned that it not be done through this particular vehicle because this particular vehicle has very adverse, presumably unintended, consequences on the structure of finance in this country that leads me to conclude that it is far too high of a price in inefficiencies and potential systemic risks to pay in order to get a proper balance of supervision and regulation.

Mr. Chairman, in that context, we are more than willing to sit down with anybody and find a way to increase as much as they think it is appropriate for them, where their powers lay, and if it comes out of the turf of the Federal Reserve, so be it. We don't care particularly much about that. We do care and we care very strongly that the structure of the financial system, and the regulation which is embodied around it, be sound and not create the type of systemic problems that concern us as our major responsibility.

Chairman LEACH. I appreciate that. My time has expired, but I do want a one word answer to a question I'm going to be putting to Secretary Rubin as well. At the end of the last Congress there was enormous reluctance from both the Treasury and the Fed to meet. If at the end of this hearing process issues of a given nature

are not resolved on the regulatory front, will you commit to meeting with appropriate representatives of the Hill and with Secretary Rubin to try to work out a compromise?

Mr. GREENSPAN. By all means, Mr. Chairman.

Chairman LEACH. Thank you.

Mr. LaFalce.

Mr. LAFALCE. Thank you very, very much, Mr. Chairman and Chairman Greenspan. Chairman Leach and I, and I think you and Secretary Rubin are very, very close, and we just need to reach for that final compromise.

The House Banking Committee did report out a bill last year, or two years ago, I'm sorry, the last Congress, which included an operating subsidiary provision. And both Mr. Leach and I voted for passage of the committee print out of committee, in any event. That was deleted from the product that went to the House floor.

In my conversations with Treasury, I, along with Mr. Vento and Mr. Bentsen, offered an amendment that did not go as far as they wanted at that time. It did not include insurance underwriting, but it did go further than the committee print. It included merchant banking. And that was defeated. Treasury did not say they supported it at that time because they wanted more in it. I've had a lot of conversations with them, and now they've agreed that they would forego additional powers, such as an insurance underwriting.

And we also included a number of provisions in the bill that I introduced yesterday, along with the support of a good many other Democrats of this committee and Republicans, either on the committee or in the full House. The bank would have to remain very well capitalized and well-managed and would take sanctions if it failed to do so.

Second, a capital deduction would apply and, thus, every dollar of a bank's equity investment in the subsidiary would be deducted from the bank's capital.

Third, restrictions under Sections 23(a) and 23(b) of the Federal Reserve Act would apply.

Fourth, the bank could not make an equity investment in a subsidiary that would exceed the amount that the bank could pay as a dividend.

Now, the next two are especially important because we've prevailed upon Treasury in an attempt to show tremendous compromise with you, and this is very new. The activities of the operating subsidiary would be subject to joint rulemaking by both the Federal Reserve and the Treasury.

And, finally, with respect to merchant banking, it's the Fed that would have the rulemaking authority with respect to those activities of the op-sub.

I just wanted to make sure you were aware of that because that's a tremendous outreach to the Fed, above and beyond anything. Now, I posit that to you, and in conjunction with that, I point out to you that you, and I approve of what you've done, have approved eighteen requests by foreign banks to have operating subsidiaries in the United States that engage in securities underwriting activities in the United States, properly referred to as Section 20's. I think U.S. banks are at a competitive disadvantage.

What is of interest to me is the reasoning that I believe the Board used in making these eighteen approvals and allowing these op-sub activities for foreign banks. You said a capital deduction would be required, as we do. Strong regulatory restrictions would be required, and we permit you to either have co-equal authority or exclusive authority with respect to those regulatory restrictions. And I believe the rationale of the Fed in making those approvals was that with those regulatory restrictions in place, you believe there would be no conflicts of interests or unsound banking practices.

What's your comment about that tremendous outreach effort, regulatory approach, and the juxtaposition of those outreach efforts, and what you've done with respect to foreign bank op-subs?

Mr. GREENSPAN. Yes, first of all, let me just say that the issue for us is not our authority over the operating subs. In other words, you could give us all the authority over everything with respect to operating subs, and we would oppose putting the powers in there. It's not a turf question. It's an issue of structure. In other words, the issue of the Treasury giving us, as you put it: "all of that power" is not relevant to this issue. You could give us full authority over operating subs, and we would very strongly recommend that that be rejected. It's the issue of the question of subsidized equity going from the bank down to the sub, which creates the problem, the unlevel playing field.

Mr. LAFALCE. But didn't you address that issue with respect to foreign banks?

Mr. GREENSPAN. Well, I'll get, that's a side——

Mr. LAFALCE. And then also there's another consideration too, and that's the coverage of the CRA, which is very important to a good many Members.

Mr. GREENSPAN. Why don't I answer the first?

Mr. LAFALCE. Sure.

Mr. GREENSPAN. And then we can get to the next question. With respect to foreign banks, for which we are required to create so-called "national treatment," there is a difficulty because foreign banks do not have holding companies. And what we have done is we have chosen to presume that the universal bank is the holding company and the subsidiary is like an affiliate of the holding company, and we supervise and regulate it in precisely the same manner that we do our domestic affiliates, so-called "Section 20 affiliates." We would never allow an issue of foreign bank structure to effectively determine how our system functions.

Mr. LAFALCE. The solution, if you could presume that operating subsidiaries of foreign banks are affiliates, why don't you presume that operating subsidiaries are affiliates? And we would accept your presumption.

Mr. GREENSPAN. No, because basically the issue is the question of our system versus theirs. They do have universal banks, say in Europe. And they do, indeed, subsidize them. And their operating subs do, in fact, have all the characteristics which concern us. I submit to you that the universal bank system, by the way it functions with cross-subsidization of various different elements, has clearly turned out to be an inferior means of banking structure. And we, that is, the United States, have exhibited skills in banking

and structure and the capability of putting forward services which have out-competed all of them.

So are you asking me are the universal banks that we allow in here to have Section 20's subsidized by their foreign governments? The answer is yes, they are. Do we allow that to have a competitive edge within the United States? We do everything we can under national treatment to prevent that from happening, and I think we succeed.

Mr. LAFALCE. Didn't your internal discussions say that this subsidy was so date de minimis to be of no real world consequence?

Mr. GREENSPAN. When?

Mr. LAFALCE. That's my understanding.

Mr. GREENSPAN. No, the de minimis part is when you use agency. The size of the subsidy is directly related to the amount of equity capital that moves from the subsidized entity, the bank, to the sub. We believe that agency functions, powers, have de minimis subsidization because the amount of capital that is required for most, in fact, virtually all, agency activities is exceptionally small. And we can scarcely argue that if it's the size of the equity which carries the subsidy, that there really is any to speak of in agency activities. We have never said that the issue of moving capital into the sub of a bank is de minimis so far as subsidies are concerned.

Chairman LEACH. Thank you.

Mr. McCollum.

Mr. MCCOLLUM. Thank you very much, Mr. Chairman. It's been reported that Senate Banking Chairman Phil Gramm has said that you and Secretary Rubin are very close to reaching an agreement to allow operating subsidiaries in banks of assets under a billion dollars, is that accurate?

Mr. GREENSPAN. From our point of view, the issue of the amount of subsidy that is likely to occur from a small community type bank is not all that much different from the issue of agencies. That is, I cannot—I don't like the idea of doing it—but I cannot argue, on the basis of the principles which I have been expounding, that a small amount of subsidy does any systemic damage.

The problem basically, however, is that the safety and soundness issues with respect to using the subs are independent of the size of the operation. I, in earlier testimony before this committee, didn't want to press the issue of safety and soundness because I didn't think it was a terribly important question. The more I thought about it, frankly, the more I've been pounded on by some of the people in my organization, the more I suspect they are more right than I. And they used a very interesting example. They said that consider the case, and I won't use names, but back in 1987, we had the sub of a major bank lose all its capital in hours. This was during the stock market crash. And that had a very significant impact on the bank. And that creates a safety and soundness problem for the bank.

Now, if you ask me from the subsidy point of view, would I be terribly concerned about a billion dollar limit? I couldn't argue that strenuously. Safety and soundness I can. To my knowledge, however, Secretary Rubin cannot accept a number which is a billion dollars.

Mr. McCollum. Well, thank you for clarifying that because that has been batted around quite a bit.

Mr. Greenspan. I don't want to speak for Secretary Rubin, it's just my understanding of where he stands on these issues.

Mr. McCollum. Right, but it certainly clarifies whether you're close to some agreement with him, which has been reported on this point. And I appreciate your clarifying that, that it sounds like you're not.

With respect to the question of commerce and banking, I read into what you said to us today that you do believe that in the long-run that an integration, a full integration of commerce and banking is something that is probably desirable or is likely to take place. It's just a question of two stages, as you put it. Is that a fair interpretation of your thoughts?

Mr. Greenspan. Well, Congressman, let me suggest what the nature of the problem is. As technology changes and as the nature of how we produce goods and services changes, especially in the financial area, the dividing lines between different types of financial products and different types of institutions gets increasingly blurred. And while it's not yet readily the case in a lot of areas, it's beginning to also blur between commerce and banking. If there were no subsidy issue with respect to the bank, if we didn't have the safety net, deposit insurance, the discount window, and Fedwire, then, in my judgment, there should be no reason to even discuss the question of whether a commercial institution can buy a financial institution. There are no subsidies. There's no reason why they shouldn't.

Mr. McCollum. Well, let me ask a clarification right there. Can you tell me how does a holding company benefit from the subsidy if it buys a bank?

Mr. Greenspan. You mean a financial services holding?

Mr. McCollum. Yes? Well, yes, the bigger company? Presumably, it's a financial services holding company that has a commerce face?

Mr. Greenspan. Yes, if I'm a holding company and I buy a commercial bank, the market value of the bank capitalizes the subsidy in the bank. Therefore, to the extent that I own, as a holding company, the commercial bank, the market value of the financial services holding company is higher. So in that regard, there is some spillover that occurs from the subsidy into the holding company. It is very small and very well contained and has not created, in our judgment, anything even close to systemic problems. And, therefore, we have not considered it an issue.

The moving of the subsidy into financing these new powers—whether it's in the bank or in the sub doesn't matter—financing with the sovereign credit of the United States matters. It has a significant impact. And it creates the type of financial structure which is, in my judgment, potentially unstable.

Mr. McCollum. Thank you very much, Mr. Chairman.

Chairman Leach. Thank you.

Mr. Vento.

Mr. Vento. Thanks, Mr. Chairman. And welcome, Chairman Greenspan. Just an observation on commerce and banking, I think that the issue today is, I mean I think most of us would like to be

cautious. I think putting a recognition of it into the legislation, rather than leaving it really to be defined by yourself and others, is I think an invitation to some problems.

I think, too, that the end-product that we had on the floor in the Senate was a 15-year grandfather for securities and insurance and no provision for banks. And my only judgment is that in an electronic age that that 15-year difference with structure would create a different type of symmetry than would be the case if, in fact, we recognized it within the law. And, of course, these are the practices of securitization and the reason we have them trotted before us. And I think almost, well, I say nine out of ten witnesses yesterday at least were friendly to the idea and the recognition of the way the market works. So I think that while I don't know that we need to—I think we need the type of safeguards and concerns, I mean I agree with that, but we ought to be cautious in this area. But I think not to recognize it is to invite some convoluted type of symmetry. Obviously, you spoke effectively here with regards to unitary thrifts and the problem that represents, but we've got CEBAs in this bill. We've got, obviously, the U.S. banks operating abroad that have these relationships. Plus we have, of course, the whole range of State regulated institutions, which are under a different set of guidance with regard to this.

And that brings me back to your suggestion about the sovereign credit being used. And, of course, I understand that there is a difference here today in the sense that the subsidiaries don't have the merchant banking power. We've limited that, of course, in the legislation that Congress and Mr. LaFalce and the amendments that we've offered, and now has been endorsed pretty much by the Administration, this merchant banking, which is substantial, which is I think the core of what the powers are. But insofar as the sovereign credit exists within States, it exists within U.S. banks operating abroad, the sovereign credit then do you agree is pass the affiliates that are operating in those instances? And what guidance, a brief answer, Mr. Chairman.

Mr. GREENSPAN. It is certainly the case that we have edge corporations, which are constructed by the Congress for purposes of meeting the competitive structures of American banking institutions abroad. As I mentioned earlier, they do subsidize their commercial banks and their whole system. What we do through edge corporations is effectively replicate the type of structure that they have abroad. Those institutions are subsidized. And the reason that we have chosen to do that is to maintain a level, competitive playing field between American institutions and foreign institutions, say in Germany or France or elsewhere. It's precisely that principle which is the reason why we do not recommend subsidization here because in order to maintain the level playing field abroad, you need the subsidization. To maintain the level playing field in the United States, you should not have it.

Mr. VENTO. Well, we do have it apparently in the context of State regulated institutions that are insured by the FDIC?

Mr. GREENSPAN. Well, if you're referring to the subsidiaries, the subs of the banks, the truth of the matter is that there is very little of that. There are almost no securities operations even though they are legally authorized in State institutions. There is indeed very

little in the way of subsidies flowing from mainly smaller institutions into their subs. Theoretically, I agree with you. It could become or could have become a problem. The fact of the matter is it has not.

Mr. VENTO. Well, the FDIC, of course, has to approve all the activities. And so in instances where we have had that problem, obviously there was some problems with regard to thrifts during the 1980's when we thought giving them more powers would somehow magically work them out of their problems. But in this legislation we have, we limit the amount of capital. And, of course, in this instance, the sub has to be well-capitalized. And the parent institution has to also.

Now, in the example you gave with regards a certain trading bank that had an affiliate that was doing some trading in stock, I remember I think the same instance. The fact was—the question is whether the bank is well-capitalized. If it isn't, that's a problem, and, of course, it's a regulatory problem beyond that. I mean the same could probably be said with regards to an affiliate structure if it's not capitalized, in my judgment. I realize you might differ with that.

But you are aware there's a 10 percent limit in terms of the capital that can be invested, it can be no greater than the dividends that are paid. So there are a number of other procedural safeguards in here. And, of course, as you know, the FDIC former chairman, none of which all agree that this is equal and do not agree that there's any subsidies, so there is—and no sovereign credit being used here. I mean we could probably go through this around and around and say that the Fed window and some of the other activities represent sovereign credit.

Mr. GREENSPAN. Well, the answer is the Fed window does. That's precisely the problem. But we can only lend to commercial banks by law. That's what the issue is.

Look, I can conceive of a situation in which you can create an operating sub of a commercial bank and give them all of these powers, but then proceed to find every form of restriction to make sure that they can't really use them. I will submit to you that no one is going to want that structure. The reason why there is such a strong support for the issue by the banking community originally for operating subs, is, indeed, it is a terrific advantage for the banks. In other words, I will suggest to you that if I were a CEO of a banking organization and given the opportunity to have an op-sub with these powers, and I didn't move the powers from the affiliate of the holding company to the sub of the bank where it is subsidized, I would presume the shareholders would kick me out for misusing the funds of the banking organization. And what I'm saying is the fact that if you tie the sub up in such a manner as it effectively doesn't function, no one is going to want it.

Mr. VENTO. We're trying to answer the responses that you have, and so that's the fear though. I would say that will we be able to submit written questions, Mr. Chairman.

Chairman LEACH. Absolutely.

Mr. VENTO. Yes, thank you. I have one on insurance, thank you.

Chairman LEACH. Mrs. Roukema.

Mrs. ROUKEMA. Thank you, Mr. Chairman.

Chairman Greenspan, I am particularly happy that you have repeated yet again for our newer Members, who haven't been here and had this long history of the fact that we have not been able to get statutory changes and the law passed for financial modernization. And so you made a strong case that if we don't do it now, we will have lost the opportunity for the indefinite future. And we'll continue, not only in an ad hoc basis, to have the regulators and the courts, because we're abrogating our Constitutional responsibility. The regulators and the courts will be taking over our responsibility. That will be a great detriment, not only to the country and to financial institutions, but to the reputation of the Congress. And I thank you for stressing that again.

But I am also encouraged today by what you've said on the subject of finding, if not a compromise, a way of dealing with the holding company and the op-sub question. There is a division between yourself and the Treasury. I agree with you.

And I am especially happy that you have responded, and I think it was Mr. LaFalce's question, that you took the opportunity to respond to the question that I was going to ask. The question is can't you put your position on why the operating subsidiaries is not the way to go, as not just turf. Whether you know it or not, there's an awful lot of people around this town and Members that are saying, "Oh, this argument is just about turf. There's no substance to it." But I want to congratulate you. If you want to say anything more on that subject I'd appreciate hearing it, but I think you've really addressed the substance of the issue here. And I hope we've all heard it. These are substantive concerns, and not just turf. And, hopefully, from what I read in *The Washington Post*, Mr. Rubin is ready to discuss these substantive issues with you, and we'll be asking him that tomorrow. So if you want to talk about that again, I would be happy to hear what you have to say.

But I did want to get to this question of commerce, and I won't use that dirty—it's become a dirty word, "commercial basket," you know I'm committed to a basket, but it's not a word that we use in polite company evidently these days. But I like a basket, whether it's a 10 percent or 5 percent, but it looks now as though there's serious conversation and discussion about complementary activities. And I think you addressed it in some respect with Mr. Leach and another questioner. But my concern, and I hope you address your comments to this, is that it sounds good, but would it be too convoluted to really be workable? Can you address what my concerns might be? Any compromise language where we're using "complementary activities" as the statement? And from what I've heard, and I haven't studied it, there's nothing specific to study yet, but it sounds too convoluted from a regulatory perspective to be effective in my opinion.

Mr. GREENSPAN. Well, maybe not. I think starting with the premise that we are all aware that there's a gradual blurring and increasing blurring between banking and commerce and that at some point down the road, we're going to have to be addressing that because if we don't address it, it's going to happen automatically. And, as I said earlier, the problem is the safety net. If you didn't have the subsidized safety net, this issue would not arise.

And so it's a question, how do you minimize the use of subsidies in the system as you begin to blur this particular area? I would suspect that if you grant to the banking regulators and others the ability to interpret that term in a manner which is consonant with the goal of gradually endeavoring to move in the direction recognizing the changes in technology, but trying in the process to significantly minimize any spillover from the subsidies out of the banks, I think we should be able to do that.

Mrs. ROUKEMA. In a timely manner or we going to be months or years through regulatory interpretation?

Mr. GREENSPAN. I would say it's likely to occur gradually as it should because there's no urgency at this particular point. And the main issue, as I've said, is to see what happens with financial services holding companies and we'll learn about how to go to the next step, if it's even decided to go to the next step.

Mrs. ROUKEMA. Would it be done on a comprehensive basis or case by case basis, an individual application basis?

Mr. GREENSPAN. I suspect it's probably likely to start off case by case.

Mrs. ROUKEMA. Like Citicorp and Travelers?

Mr. GREENSPAN. It could be, yes.

Mrs. ROUKEMA. All right. Thank you. I don't know what conclusion I've come to on that, but I do hope that we can work together on it and pursue it. In any event, we must pass legislation this year. And we appreciate your continued leadership.

Mr. GREENSPAN. Thank you.

Chairman LEACH. Thank you, Mrs. Roukema.

Mr. Kanjorski.

Mr. KANJORSKI. Thank you very much, Mr. Chairman.

Mr. Greenspan, I do not want to paraphrase your testimony, but as I understand it when you are talking about the mixture of commerce and banking, it should be thought of as a two-stage process. That is, we can first do modernization and free up some powers for banks. But, we do not necessarily have to allow them to have any portion of a basket or anything in commerce until, somewhere down the road, after we understand the experiences of what is happening domestically and also have had an opportunity to analyze Japan, Germany, and some of the other banking crises that exist in the world. Is that substantially what you are saying? We should make no compromise, and keep the firewall until we have a better knowledge?

Mr. GREENSPAN. Yes, sir.

Mr. KANJORSKI. In that light, it is still worthwhile to have modernization. Not mixing commerce and banking does not take away modernization. There are other powers out there that are worthwhile. But one other question, has anyone given thought to the possibility of establishing a super bank charter? If, in fact, these banks are not seeking subsidies, why not allow them to engage in commerce and banking, but take the open window, take the FDIC away from them, and take the Fedwire? And if we took those three subsidies away from them, do you think there would be a rush for a super bank charter?

Mr. GREENSPAN. I doubt it.

Mr. KANJORSKI. So, it really is that attempt in some way to gain a subsidy and pass it on into a commerce business? Now, retiring from all of that, do you have any good sense as to whether the Japanese crisis and the German crisis, have subsided to the level that we should not have to worry about it too much? Or is it worthwhile for you to give us an indication about how long a period of time is needed to see what is the effect over there of their structures?

Mr. GREENSPAN. Well, we don't have to look beyond what we've seen because we've learned a great deal. One of the things that is beginning to evolve, Congressman, is an awareness that there's something unusual about the fact that we in the United States, say last August after the Russian default, did not sense a significant impact. And the reason appears to be that even though part of our intermediation of savings and investments froze up, we couldn't, for example, for a period of time even get a market in fairly high-grade bonds. You couldn't sell them. The thing seized up. But the commercial banks then took over. We had sort of two means to intermediate savings and investment.

The same thing happened to us back in 1990 with the savings and loan crisis. That is, the depository institutions froze up, but the securities markets solved the problem, so to speak.

One of the things that appears to be the case is in East Asia where universal banking is the only means they have, is that it worked fine so long as the economy was growing. As soon as they ran into trouble, they had great difficulties. It's like the person without health insurance. He isn't concerned about it. Everything is going fine, but when he's ill, it's a problem. Well, in a sense, they didn't have any health insurance. We did.

And that shows up in Japan as well, where they have the vast proportion of their intermediation between savings and investment in commercial banking. Commercial banking serves a far greater proportion of their activity than ours. And when their banks ran into trouble, their whole economy ran into trouble.

So in that sense, we've already learned enough. And in Europe we can see the process by which, as I mentioned earlier, the cross-subsidization, which takes place within these general universal banks or, in fact, in the keiretsus in Japan, that process does not work well in a crisis. Ours apparently is sufficiently flexible that it does.

So I don't think we have to await what is happening on the financial part to make judgments about holding companies or universal banks now. But what I was saying is that the experience that we will get in the United States from seeing how the subsidy is contained in the financial services holding company will give us insights on how to go the next step successfully if the Congress chooses to make that judgment to move in that direction.

Mr. KANJORSKI. It sounds as if, in your judgment, the second stage should not come for a long time because our system seems to have greater flexibility in these stressful times, is that correct?

Mr. GREENSPAN. I don't think we know how long the second stage would be. That's going to be determined more by technology than by regulation or even markets. If the technology moves very dramatically to blur the lines between say a financial services holding company and commerce, then I think the Congress is going to

have to address that issue fairly expeditiously. If it is moving slowly, I think there's may be a considerable amount of time before that issue needs to be effectively addressed.

Mr. KANJORSKI. Thank you very much.

Chairman LEACH. Mr. Bereuter.

Mr. BEREUTER. Thank you, Mr. Chairman.

And, Mr. Chairman, thank you for your testimony. I'm particularly interested in the subject that you and Mr. Kanjorski were pursuing. I also liked the reiteration of what you said several years ago in your statement today about the caution you raised on early movement to integration of commerce and banking. It seems to me that we would be absolutely foolish if we ignored the examples of what has happened in Asia. When the Japanese economy was moving ahead quite strongly, the assets of the banks, of course, increased. But now they've been in a slump for seven years and when they need a strong banking system to help spin them out of that recession, they don't have it. And whether you call it a basket or some other euphemism, I think it is a dirty word at this stage. I would hope that my colleagues, and particularly the interests here, understand that it should be a dead letter issue at this point.

If we have to strike it out on the floor again, I will lead the effort to strike it out. It is such a serious blunder, that it should not impede our effort to go ahead with banking modernization.

Now, Mr. Chairman, I do have a question, two actually. In your testimony, you stated that principal activities are conducted in bank subsidiaries. Those subsidiaries will have an unfair competitive advantage over independent insurance and securities firms, or even over an affiliate. Could you give us a little more detail on that? And, relatedly, could you explain how allowing operating subsidiaries could distort "the efficient allocation of both financial and real resources that have been so central to America's current prosperity"?

Mr. GREENSPAN. First of all, let me just say that there's very substantial evidence on this issue of the fact that there is a subsidy in the bank. One of the many indications is the fact that if you take a look at the ratings of issues of debentures of banks on the one hand, by themselves, and all other unrelated institutions, insurance companies, investment houses and the like. At the same rating, the bank will have significantly less capital, meaning far more leverage, than will the other institutions. The sole exception to that are a few of the large investment institutions which have very large what we call "matched books," meaning very large amounts of U.S. Treasuries or other safe instruments on their assets side, which don't require any capital. So that distorts the picture.

But there are a whole series of other measures which unequivocally support the notion that there is a subsidy in the bank. Every banker knows that. When I was in private business and consulting with a lot of banks, it was a given that you moved every power you could into the bank where the cost of capital is the least. It was never even a debatable issue. I never even heard it debated until I arrived here. It struck me as there are certain truisms around the world.

The problem essentially is that that then means that a banking institution, having a lower cost of capital, is able to compete unfairly and on an unlevel playing field with those institutions who don't have access to the safety net. What occurs is that the allocation of capital is distorted. Ideally, we say that capital is appropriately allocated when the pricing system reflects the value preferences of consumers, because that will induce the type of physical assets that are produced and the type of goods and services that are produced that consumers want. You distort the system through subsidies, and you will unbalance that system. And it's the reason why so many economies, which are heavily subsidized, work so poorly.

Chairman LEACH. Thank you, Mr. Bereuter.

The gentleman from Vermont, Mr. Sanders.

Mr. SANDERS. Thank you, Mr. Chairman.

And, welcome, Mr. Greenspan. Mr. Chairman, let me begin my remarks with a brief quote from a gentleman I think we're going to hear later this afternoon. He's a good friend of mine, Ralph Nader, and he says, "H.R. 10 is not a bill for consumers. It is a bill designed to create new profit centers for a relative handful of banking and financial service corporations that will form combinations which will dominate the delivery of financial products and fuel the already alarming trend toward megamergers and the concentration of economic power."

Mr. Chairman, in recent years we have witnessed what I consider to be a very, very dangerous trend in this country. And I'll be asking Mr. Greenspan about this in a moment, and that is that there has been merger after merger in industry after industry, the result being that fewer and fewer extremely wealthy and powerful individuals own and control more and more of our economy. On an individual basis, we now have the most uneven distribution of wealth in the industrialized world, with the wealthiest 1 percent of the population now owning more wealth than the bottom 90 percent. We have one individual owning more wealth than the bottom 40 percent of our population.

From the point of view of our economy and the international economy, we have seen extraordinary mergers in the media and telecommunications and banking and manufacturing, agriculture, and in almost every area of our lives. The bottom line of all of that is that a relatively few extraordinarily wealthy and powerful individuals now control a significant part of our economy and the lives and well-being of tens and tens of millions of Americans and people throughout the world.

Now, Mr. Greenspan, I believe will remember that the last time he visited with us, he was here to defend the Fed's action with regard to the Long Term Capital Management fund, a hedge fund which created a major international financial crisis because of the irresponsible investments of more or less one man, Mr. John Meriweather, the so-called "master of the universe," as I guess he was referred to on Wall Street. And this is one guy who made some bad investments which caused Mr. Greenspan and his colleagues to move rapidly because they were worried, I think the word you used was a financial "meltdown." One man.

My concern is that if we continue the trend toward fewer and fewer large financial institutions, we are going to raise the crisis of the too-big-to-fail doctrine. And if it is already scary where we are right now through the savings and loan failure to what happened to Long Term Capital, I wonder what happens when you can have fewer and fewer financial institutions who, if in dangerous financial situation, are going to call upon the United States Government and the taxpayers of this country to bail them out. We're not going to have the resources to do that.

So my question for Mr. Greenspan is, are you concerned about this growing concentration of economic power? Do you believe that the problems that we have seen in Asia and in Russia, where American companies have invested huge sums of money, and in some cases, lost large sums of money, precipitating serious problems at home, should give us some reason to be concerned about moving forward in the direction of H.R. 10?

Mr. GREENSPAN. Well, let me first say that it is certainly true that the dispersion of wealth has increased quite substantially. And it is indeed true that there are some extraordinarily wealthy billionaires that were not billionaires earlier. As best I can judge, almost none of this is the result of mergers. Indeed, a number of the mergers that I have observed have not worked all that well. The major reason why there has been a significant increase in wealth in that regard is that stock prices have gone up very substantially. And the reason they have gone up is that the markets have presumed that the capital efficiency of the American economy has improved in a very significant manner. And, indeed, the consequences of that are all around us. We have an economy which is the envy of the world. We have an economy which is functioning exceptionally well, even granted all of the numbers which I will immediately agree remain a problem, namely, a distribution of income, not to mention wealth.

Mr. SANDERS. I understand. Are you concerned about the increased concentration of economic power?

Mr. GREENSPAN. The answer is no. And the reason I am not is I think that what is happening in this economy is a major increase in competitive pressures throughout this economy, and that, indeed, the issues that appear before the Antitrust Division are very interesting in the sense that they are no longer the huge conglomerate types of problems which were perceived to be hobbling the underlying efficiency of the American economy. This is an economy which is an extraordinarily competitive one, and the reason is that technology has moved so dramatically.

Am I concerned that some of these mergers are not going to work? Yes, I am concerned. I think some of them are not going to work and are going to create very significant problems for their shareholders and I hope few others.

Mr. SANDERS. Not the taxpayers?

Mr. GREENSPAN. But I'm not worried about the broader question that you raise.

Mr. SANDERS. You're not worried about the taxpayers having to bail to out these institutions?

Mr. GREENSPAN. I should certainly hope not.

Mr. SANDERS. "Hope" is a word that concerns me.

Mr. GREENSPAN. Well, let me put it this way. The LTCM, the Long Term Capital Management, as you know, had nothing to do with taxpayer funds.

Mr. SANDERS. I am aware of that.

Chairman LEACH. Mr. Baker.

Mr. BAKER. Thank you, Mr. Chairman.

Good morning, Mr. Chairman. For the purposes of my question, would like to put the debate about subsidy on the shelf just for the moment and turn more to structure questions as to operating subsidiary versus affiliate structure. I find it of some interest that under the provisions of the Bank Holding Company Act, under the Fed's regulation, a domestic U.S. bank may invest up to 24.9 percent in a United States corporation. And under similar provisions of that Holding Company Act, under Fed supervision, a U.S. bank may own up to 40 percent of a foreign corporation.

One might well ask the policy question, why is it safer for a U.S. bank to invest in a foreign corporation than it is in an American corporation even at a higher investment ownership? It's not my question; it's just the point that equity investment, in a commercial enterprise, is now an activity permissible under the Bank Holding Company Act. So it would appear commerce and finance, as a matter of economic policy is not something that should be prohibited.

Merchant banking, as I understand it, would simply allow U.S. banks to take equity positions in corporations in perhaps an operating subsidiary. So structure becomes the issue. Do you do it through the Bank Holding Act, under the affiliate, or do you do in the operating subsidiary? Not the issue of is it permissible or advisable?

But I understand that the Fed's position on merchant banking in the operating subsidiary is that of opposition. It would appear that the argument being made is one of structural distance, that the further away from the bank one engages, in either underwriting securities or merchant banking, one can then assume that it is inherently safer for the taxpayer?

Mr. GREENSPAN. Not the taxpayer, the structure of the system as a whole.

Mr. BAKER. Systemic risk. So let's make that assumption and then proceed to suggest a new format, that we do not allow securities underwriting in the op-sub. In fact, for the sake of this question, let's not allow it in the holding company. Let's not allow banks to participate in the securities business at all except by traditional commercial lending activities. And don't even make it in the neighborhood. Let's make it some far-off place like Connecticut.

Now, one would assume that that would be a very safe and sound transaction, if structure is truly our defense. My point here is that market experience tells us otherwise thankfully. The Fed did get involved in resolution appropriately due to concerns of systemic risks. And it leads me to the conclusion that structure in itself is not the safety net for the system, that it is regulatory capability and multiple regulators. Your point. If you were to allow these activities to occur in an operating subsidiary, not only would the Fed have direct jurisdiction over that operating subsidiary if concerns were raised about the safety and soundness of the bank,

Treasury would also from a different perspective have jurisdictional interest in that operating subsidiary's activities.

And that would mean additional regulators, not additional structure. It means more efficiency in handling those transactions, which you already allow under Section 20 affiliates for securities. The Fed approves and allows securities investment by banks, through Section 20; approves and allows merchant banking, although it's called "equity investment" through the Bank Holding Company Act. So we're not disputing these activities are appropriate. We're only arguing as to the structure being the appropriate safety gauge for the system and the taxpayer. And recent history tells us that structure is not the protector that we all hope would be. It has to be competent regulators in that bank and, in my view, multiple regulators. And that's what the operating subsidiary structure would give us.

Can you comment, please?

Mr. GREENSPAN. Well, first of all, if there were no subsidies within the bank, then the structure would be wholly an issue of management convenience. You would still raise the issue with respect to the cross-subsidization that exists in a universal bank which history now suggests to us.

Mr. BAKER. I agree with your point. And I'm not disputing that. The only thing I said at the outset is that we could put subsidy on the side for the moment.

Mr. GREENSPAN. But that is, in my judgment, begging the question. If the subsidy did not exist, I would say that the Government should have no function here whatsoever.

Mr. BAKER. All I'm trying to raise for my colleagues is that you are opposed to the structure because of the subsidy, not because inherently commerce and finance or underwriting of securities or merchant banking or those activities in themselves present a problem to do it within a bank structure other than your concern as to subsidy?

Mr. GREENSPAN. That is correct.

Mr. BAKER. Thank you.

Mr. GREENSPAN. Except with one caveat.

Mr. BAKER. Yes, sir?

Mr. GREENSPAN. The caveat is the safety and soundness question which relates to the bank itself, that what we have observed in the past is that if you have a subsidiary of a bank, which loses all its capital very quickly, then it has a major impact on the bank itself. And to the extent that banks are a crucial aspect of our intermediary process, if you get a number of those types of problems, then you undermine the banking system. That is not an issue of subsidies per se. Subsidies are the crucial issue. But it is not as though it's irrelevant where one keeps the particular powers because if I were corporate management, I would be very careful where I kept my particular powers. If it were not for the subsidies, I would tend very much to keep them in the holding company affiliates where liability was limited and did not undercut the crucial issue of the bank.

Mr. BAKER. I don't have a further question, just a comment with regard to the holding company structure and regulators' ability to force liquidity down to the bank in the case of difficulty. I'm told

a recent court decision is now requiring the FDIC to reimburse to the rate of $120 million to debtors of the holding company where the regulators forced the holding company to downstream capital to a troubled financial institution. And the courts have found that to be an inappropriate activity of the FDIC.

Mr. GREENSPAN. Well, I think that's a legitimate problem.

Mr. BAKER. And getting the money downstream from the holding company to the bank is far more difficult than getting it from the op-sub up to the bank is my point.

Thank you for your courtesy, Mr. Chairman.

Chairman LEACH. Thank you, Mr. Chairman.

Mr. Bentsen.

Mr. BENTSEN. Thank you, Mr. Chairman.

Chairman Greenspan, in your testimony you talked about an obsolescent mode of regulation and that bank regulations was mired in 19th Century structures. What if we dropped the idea of the op-sub and instead said that the Fed should concentrate on monetary policy, the clearinghouse, the Fedwire, Reserve requirements and liquidity, Fed funds; and moved the bank regulatory powers to the OCC, including the bank holding company structure and State banks, would you agree with that?

Mr. GREENSPAN. Well, we've discussed——

Mr. BENTSEN. I think I know the answer.

Mr. GREENSPAN. Yes, we've discussed that at length in previous discussions. It depends on whether you think that the lender of last resort function is enhanced by having hands-on supervisory authorities and knowledge of the details of the banking system. And, as I mentioned the last time we talked about this thing, so far as the Fed is concerned, as you know, we have got the holding company structure, which gives us insights into a lot of the major banking corporations. We have onsite supervisory activities in some of the larger State member banks. And a modest amount of smaller banks which enables us to understand what's going on in the banking system in general. It's been our experience that to have a detailed knowledge and be able to deal with individual banks and bankers when the crises arise, has been a very important issue with respect to our ability to maintain our role as the protectors of the system as a whole. It's not just necessarily true in theory, I'm just merely saying as a practical matter, that's what evolved over the decades. And I think that the judgments that people in our institution are making on that, as best I can see, are correct.

Mr. BENTSEN. Well, it's a long no. But I understand that. Let me ask you this. You talked about the idea of subsidized equity capital from the bank to a subsidiary. And we've talked about the subsidy before. In fact, last year or two years ago, I can't remember when we talked about this issue, your concern was purely the subsidy and, in fact, you stated that you didn't think there was a safety and soundness issue. You've since revised that opinion, fair enough.

But, again, how is there a difference in subsidy capital or subsidized equity capital that runs from the bank to the subsidiary versus subsidized equity capital that runs from the bank through the holding company to the affiliate? I mean use an example, J.P. Morgan sets up a Section 20. Now they either do that with excess capital within Morgan Guaranty or they go into the market and

raise capital which some would argue also has some subsidy attached to it because of the fact that J.P. Morgan has some access to the sovereign capital. What is the difference, and is it a quantifiable difference between that and going to an operating subsidiary? And has the Fed, at least over the last two years, been able to quantify that difference because nobody else has apparently?

Mr. GREENSPAN. Well, let me suggest to you what we know about this issue. One of the interesting aspects of the individual holding companies is that the dividends, which are paid from the bank to the holding company, say from Morgan Guaranty to J.P. Morgan, tend to be related to the total amount of dividends that are paid from J.P. Morgan to the shareholders or from J.P. Morgan to debenture holders. In other words, the subsidy moves out of the system back into individual shareholders directly.

What is most interesting about this whole process is one would ask the obvious question why are they not moving a far greater proportion of the dividends from Morgan Guaranty to the affiliates of J.P. Morgan and use the subsidized capital as such? The answer is that if you take dividends out of the bank, you are lowering the capital. And all bankers' experiences are that that would increase the cost of funds for the bank. And, as a consequence of that, they tend not to do it. Not only is that true in the Morgan structure, and I speak from personal experience having been on both boards, it's true of all of the bank holding companies that we see.

Mr. BENTSEN. But with the Chairman's indulgence, wouldn't the same be true if you had to separately capitalize a subsidiary, you would be reducing the net capital within the Morgan Guaranty structure to the extent you move dividends or separate capital, excess capital down into the subsidiary?

Mr. GREENSPAN. I'm sorry, repeat that again?

Mr. BENTSEN. Well, I think if I understand your argument. You're saying the reason why not all the subsidized capital is moved to the affiliates is not to reduce the net capital of the Morgan Guaranty structure, right?

Mr. GREENSPAN. Of the bank, that's correct.

Mr. BENTSEN. Of the bank. Why would not the same apply in the case between Morgan Guaranty, the bank, and its subsidiary? Again, Morgan Guaranty, the bank, would be concerned about its capital, the size of its excess capital, whether it was moving dividends to an affiliate or moving excess capital to the subsidiary?

Mr. GREENSPAN. Yes, because it turns out that the funding costs to the bank as the bank consolidated, that is, the evidence that we have, or the evidence the bankers have, is that all subsidiaries of the bank and their capital, that is the capital of the subsidiaries, are perceived as consolidated into the bank itself, which indeed is what the accounting does. And the funding costs are a function of a consolidated bank, not of the bank less its' subsidiaries.

Mr. BENTSEN. And the asset of a subsidiary would be a considered an asset, a good asset, of the consolidated balance sheet of the bank and, thus, would enhance the funding capability of the bank itself?

Mr. GREENSPAN. Well, the point is, obviously, the extent to which the bank is profitable and builds up equity in the system, the answer is yes, it does. It reduces the cost. But the point I am making

is that the issue of the undesirability or the unwillingness to move the capital out of the bank through the holding company into the affiliates is the type of practice which from the banking consolidated system as a whole, sub-optimizes profit capabilities.

Mr. BENTSEN. Thank you, Mr. Chairman.

Chairman LEACH. Mr. Bachus.

Mr. BACHUS. Thank you.

Chairman Greenspan, I think there's a real consensus now between the financial industries as to what they want in H.R. 10. I think more than we've ever had. And we seem to have more of a consensus that CRA will not be a stumbling block, that we'll consider CRA later. And then the issue of commerce and banking, you propose that they be dealt with in a sort of step two process and perhaps that the unitary thrift issue could be considered at that time.

Regardless, I don't see that as a killer for this bill. But I will tell you that I see the Fed and the Treasury being diametrically opposed on whether to have holding companies or subsidiaries and that that is the major obstacle today to probably a bill moving. Do you appreciate that?

Mr. GREENSPAN. Oh, indeed. We have over the years had innumerable joint bills with Treasury in which we all agreed about the appropriate structure being a holding company. It's only in this most recent run through that this issue has ever come up.

Mr. BACHUS. Well, now, last year my recollection that the Administration threatened to veto H.R. 10 if it curbed these operating subsidiaries. So it came up then.

Mr. GREENSPAN. Oh, no, I'm saying, what I meant by that, I meant prior to H.R. 10.

Mr. BACHUS. OK.

Mr. GREENSPAN. The issue never came up because Treasury agreed with us with respect to the appropriateness of using the holding company affiliate structure as distinct from universal bank structure.

Mr. BACHUS. Did they agree with you or ever say in writing or orally to your knowledge or ever have the position that creating these subsidies could undermine the Federal Insurance Depository fund?

Mr. GREENSPAN. I'm sorry, you mean in earlier years?

Mr. BACHUS. Yes, you have said that the subsidiary system could actually undermine the Federal Deposit Insurance fund, which I think is the big red flag.

Mr. GREENSPAN. Yes, absolutely. The answer is yes, it can. It's not my most important objection to it. My most important objection is that employing a structure for financial services institutions, whatever you want to call them, employing the op-sub, so-called commercial bank subsidiary type of organization, as distinct from affiliates of holding companies, creates some very significant distortions in the system, which is the main reason why I've been concerned. But I certainly don't deny that there is also a threat to the bank from the safety and soundness issue and, hence, the FDIC and the taxpayer. I admit that that is a problem. I just want to make a point that I don't consider that the main issue.

Mr. BACHUS. You can see where some of us, as long as you're saying that that as a threat, with many of us that would be the main issue, and that that's really the cornerstone of the safety net under the whole banking system?

Mr. GREENSPAN. Yes.

Mr. BACHUS. Do you see any way where new powers could be given to the Federal Reserve and yet it could be set up using subsidiaries? And I say that because many of the small banks are saying they already have a competitive disadvantage. I think we all realize that. And they are saying, they are agreeing with Secretary Rubin that the holding company system might be rather cumbersome to them and that it may actually put them at an even greater disadvantage in competing with the larger banks?

Mr. GREENSPAN. Well, remember that most of the smaller banks are doing agency type of activities and they don't have a holding company, they don't need them. They would if they were to engage in merchant banking or insurance underwriting, or securities underwriting. But I submit to you that there are very, very few community banks, in my judgment, who have any interest in that whatsoever. And if that were a crucial issue, I think that could be very easily handled. I mean I agree with you to the extent that they think being burdened with a holding company when you're a small company and have to deal with that, that seems silly to me. And I can't see why legislation can't be very readily constructed to solve that particular problem.

Mr. BACHUS. OK. I appreciate your response.

Chairman LEACH. Thank you.

Ms. Hooley.

Ms. HOOLEY. Yes, Mr. Chairman, it's nice to know, having read *The Washington Post* this morning, that you and Secretary Rubin are a little closer together. And you talked this morning about being willing to talk to the Treasury.

I agree with the last speaker that the two of you being able to come together is going to be critical in passing this bill this time, so I hope that happens. My question is, what do you see as the obstacles to overcome to coming to some agreement between the two of you?

Mr. GREENSPAN. He has one view and I have another.

[Laughter.]

Let me put it this way: He and I work very closely together on virtually everything so that the fact that we have been unable to come out with the same agreement in this area is not, one, from lack of trying or from a lack of collegiality. We have both. There are just deep-seated differences which I regret, and I wish we could find a way to resolve them. And both of us I think believe that financial modernization is terribly important. That the Glass-Steagall Act is obsolete. It's creating burdensome costs that seem silly at this particular point. And I would be delighted if we could find a resolution of this, and we have tried on several occasions. And, as the Secretary put it, "Let's agree to disagree."

Ms. HOOLEY. But are you willing to sit down and work with the Treasury to find some consensus or do you think that's going to be impossible?

Mr. GREENSPAN. I'm willing to do whatever is required because I think this is a terribly important issue. And anybody who can find a way to bring us together and resolve this issue, I think will do a great service.

Ms. HOOLEY. Thank you.

Chairman LEACH. Thank you.

Mrs. Kelly.

Mrs. KELLY. Thank you, Mr. Chairman. I have a couple of questions for Mr. Greenspan, but first there is an issue that I would like to bring up that perhaps, really Mr. LaFalce is not here, so I really can't ask him and it does involve his mark. I'm curious about who is going to enforce Section 23(a), and who's going to interpret it? And I hope we're going to be able to figure out from what he's written how that's going to apply to the op-subs, how that enforcement will apply to the op-subs.

And, Mr. Greenspan, I'm not going to ask you that question because I don't know that you are that familiar with Mr. LaFalce's——

Mr. GREENSPAN. I haven't seen his mark, so I couldn't make a judgment.

Mrs. KELLY. A couple of things I would like to ask you. Would you support the merchant banking activities in the op-sub if we required joint rulemaking on what new activities are allowed in the op-sub under broader definitions that would be done between the Fed and the Treasury, and allow the Fed sole regulatory authority over any merchant banking activities out of the op-sub?

Mr. GREENSPAN. Mrs. Kelly, I answered that question I hope somewhat indirectly earlier. So just let me repeat.

Mrs. KELLY. I think you did. I'm just trying to clarify.

Mr. GREENSPAN. Yes, let's assume you gave all of the power to the Federal Reserve to handle it in any way we saw fit, I would still say it's bad legislation. It's got nothing to do with how you supervise it, who does, and what form. It's really got to do with the basic question as to whether, in fact, there is a subsidy coming from the bank into the op-sub. And it strikes me that if you gave us that power, I would be terribly concerned. I think it would be an abuse, which I would strongly recommend against. So it's got nothing to do with dividing the power, because even if you gave it all to us, we would still object.

Mrs. KELLY. Thank you very much. I want to switch gears for a minute and talk about the basket. Are you comfortable with the 15 percent, or as Senator Gramm favors, the 25 percent commercial basket? What size of a basket are you comfortable with, larger, smaller? And I'm going to ask a second question because I don't know how time is going to roll here.

Mr. GREENSPAN. Well, I'll answer the first one very quickly. The answer to the first question is zero.

Mrs. KELLY. OK, no basket?

Mr. GREENSPAN. Yes.

Mrs. KELLY. Would you be comfortable with a reverse basket?

Mr. GREENSPAN. What is a reverse basket?

Mrs. KELLY. Well, we can talk with Mrs. Roukema, but I see Mr. LaFalce came back, could I just ask you, Mr. LaFalce, what I was saying before? I'm interested, under your mark, who would enforce

and interpret Section 23(a) as it would apply to an op-sub? And maybe, I hate to take my time, but we'll let Mr. Greenspan off the hook here. If you don't mind answering that question, I would like to hear it from you.

Mr. LAFALCE. The Comptroller of the Currency would have supervisory authority over national banks and operating subsidiaries. But with respect to the operating subsidiaries, there would be concurrent jurisdiction with respect to its powers except with respect to merchant banking, for which the Federal Reserve Board would have the powers. This is a work in process though, of course. We're trying to find a formula that the various parties could agree upon. I also am very concerned——

Mrs. KELLY. Well, perhaps we can work together on something there.

Mr. LAFALCE. Absolutely, of course. There is no——

Mrs. KELLY. I'm just going to reclaim my time here.

Mr. LAFALCE. Oh, I'm sorry.

Mrs. KELLY. ——Because I'm going to run out. And, Mr. Chairman, will let you go ahead with that. Thank you. I'm returning my time.

Chairman LEACH. Well, thank you. If the gentlelady would yield for a second?

Mrs. KELLY. Yes.

Chairman LEACH. She has provided the Chairman an opportunity he never thought he would be provided in his life, and that is to define an economic term that the Chairman of the Federal Reserve Board doesn't know.

[Laughter.]

A "reverse basket," Mr. Chairman, is a precept that emanated from some in this committee that was intended to be a balancing. A basket implies the right of a commercial entity—excuse me, of a bank—to purchase a commercial entity up to a percentage of the bank's assets. A reverse basket is the precept that a commercial entity may use a percentage to buy financial assets. Both precepts, in this gentleman's mind, are flawed, but that is the definition. And if the Chairman of the Federal Reserve Board wants further help in understanding the economic dictionary, I'm available at any time.

[Laughter.]

Mrs. ROUKEMA. Would the gentleman yield? I just want to say, not that I'm being critical of Mrs. Kelly, but she referenced my name I suppose because you think I know it all. But in any case, I don't want the Fed Chairman to interpret that as meaning that I am an advocate of reverse baskets. I am not.

Mr. GREENSPAN. Not knowing what they were, I appreciate the definition, Mr. Chairman.

Chairman LEACH. But I would tell the Chairman that——

Mr. GREENSPAN. I'm most appreciative, Mr. Chairman.

Chairman LEACH.——This is political economics rather than abstract economics where the gentleman has some expertise. You did have a second more, I'm sorry.

Mrs. KELLY. Thank you, Mr. Chairman. No, I appreciate your picking up on that, and I thank you very much and yield back my time.

Chairman LEACH. Thank you, Mrs. Kelly.

The gentleman from California.

Mr. SHERMAN. In a world that I didn't think I would see where a brokerage buys a bank that buys an insurance company. Clearly, we need financial modernization. At some point, we may even need to see a merger of various financial regulators at the State and Federal level, but I think we ought to leave that to the next millennia.

And I can understand, Mr. Chairman, that your focus and greatest expertise is in the area of how we can regulate the financial institutions, what agencies should do that, and how those institutions should be structured. But I would like to move to an area that is I think far more important to my constituents, even if you have somewhat less interest or it really wasn't the focus of your statement, because in my district nobody really knows the difference between a bank affiliate and a bank subsidiary or very few. But they remember Charles Keating. And they remember people walking in to a savings institution, seeing the emblem of Federal insurance on the door, and all the hallmarks, the physical hallmarks, that for 50 years we have conditioned people, who previously may have remembered the bank closures of the Depression, to associate with security. They walked into the new accounts desk and they were walked over to the investment desk where perhaps oral statements were or were not made. But ultimately they ended up holding securities of the bank, in this case subordinated debentures, rather than federally insured deposits.

And I would like to review with you some of the things that could be put in this bill to try to learn from that lesson to see whether you think they would be helpful. And this would relate only to the activities that take place within the hallowed walls of the financial institution. And, yes, I know that one model is the day trader on the Internet, but my focus is protecting 80- and 90-year-old widows who do not invest over the Internet, and have had 50 years of experience with federally insured institutions.

The first of these would be at least within that structure to prohibit the sale of the bank's own securities, excluding, of course, its insurance products. And I wonder if you think that would be helpful?

Mr. GREENSPAN. Well, just to anticipate a lot of the questions you're about to ask, I would certainly agree that it is terribly important to make it unquestionably clear that there is no Government backing. And that whatever is deemed reasonable to assure that, we certainly are strongly supportive of. That's an issue which exists now, wholly independently of H.R. 10. And we have worked very assiduously to find ways to resolve this issue. We have not been fully successful. I mean it's very difficult to expunge that view that if you're in a bank, it's insured. And the Securities and Exchange Commission is concerned about it. We are. The Comptroller is concerned. The FDIC is concerned. And I think that we all are looking for ways to find improvement in our capacity to make certain that people understand where risks are.

Mr. SHERMAN. I would point out that one idea that there would be a separate building or office, but that's rejected because there are small banks. There are requirements of the new accounts officer, that person that you see behind the new accounts desk, not then walk over to the investments desk and be your investment counselor. But that's rejected because certain banks have small numbers of people. Then there's the possibility of a very strong warning. Something like saying, "This is a risky investment." And that is called "pejorative."

So in every area there is a wane of consumer protection against other interests. And I'll simply tell you the last time I was in a depository institution was walked from one desk to the other. I realized that if I was my 85-year-old grandmother, I would not have understood the difference.

And I would point out that a prohibition on selling the bank's own securities would be a good additional prophylactic and perhaps we would also want too, and I just want you to comment on this, to say that perhaps within a bank you sell insurance, you could sell a diversified mutual fund, but within that structure, should we allow the sale of any stocks? And somebody walks in in that structure, if they want to do it over the phone, the Internet, that's fine, but in that structure, walk out with their entire life's savings in one particular penny stock?

Mr. GREENSPAN. Yes, Congressman, I don't know how to organize it, but I certainly don't disagree with the general purposes you are projecting. If we can find ways to effectively do that, I, as the supervisor, unless my lawyers tell me it can't be done, would certainly think that would be the appropriate direction in which to go.

Mr. SHERMAN. Well, it's not working all that well now.

Mr. GREENSPAN. I agree with that. That's true.

Mr. SHERMAN. Thank you, Mr. Chairman.

Chairman LEACH. Thank you very much.

Dr. Paul.

Dr. PAUL. Thank you, Mr. Chairman.

Mr. Greenspan, in the past you have spoken eloquently about the cost of regulations and the difficulty with it. There's been some proposed regulations by the Federal Reserve, the regulations about "know your customer." And there's been a lot of comments made about this, and I was just wondering if you're considering withdrawing these regulations, this proposal?

Mr. GREENSPAN. Well, Dr. Paul, we're in the process of going through, as I understand it, a fairly standard rulemaking procedure. And one of the purposes of a rulemaking procedure is the purpose of getting people's opinions as to whether a specific rule, which remember comes from a statute of some form that the Congress passes, is a reasonable rule. And when all of those answers that we've requested from all the various different parties come in, then we'll go through a formal rulemaking process.

Dr. PAUL. Of course, the authority for this comes from an old law, an old law of 1974.

Mr. GREENSPAN. Well, laws are laws.

Dr. PAUL. Yes, right. And you have spoken out also about laws and regulations, I think very favorably for the free market and in a way advice for us that sunseting rules and laws might be a good

idea. And you have said this many times, even including the Federal Reserve Act. So if this is the case, would you support some type of an amendment to a bill like H.R. 10 to make sure that everything that we can apply within the limitation of the bill to sunset what we're trying to do here?

Mr. GREENSPAN. I wouldn't sunset H.R. 10 by itself. But, as I've said earlier to the issue to which you are alluding, I think a general sunseting provision is a highly desirable thing to do in this system. That if a statute cannot muster 51 percent of both Houses and the signature of the President, it's dubious whether it should continue to be the law of the land.

Dr. PAUL. But if it's legislatively permissible to do it under H.R. 10, why shouldn't we try if it's a good idea?

Mr. GREENSPAN. Well, the only reason I would be uncomfortable with that is that why do it in this particular legislation, which is obvious from all the discussions we've had, is a very tough thing to bring——

Dr. PAUL. Because we might not get another chance. And also——

Mr. GREENSPAN. Well, let me put it this way: I certainly approve of sunseting in general, including H.R. 10. I would hate to find out that there was a consensus on passing H.R. 10 and it failed because somebody filibustered it over in the other——

Dr. PAUL. Well, I see that as passing the buck because we're not likely to do it separately. What if we would have written a sunset law in the Glass-Steagall, maybe we wouldn't be here today and we wouldn't have been here for six years discussing this. And on the Glass-Steagall, since that's part of the problem, if not the entire problem, why couldn't we simplify this a little bit and just write a one page bill and say repeal Glass-Steagall? I quite frankly admit that I get confused on some of this stuff. I don't know if anybody else does, but I wouldn't get confused on repeal of Glass-Steagall. What would be wrong with that type of an approach?

Mr. GREENSPAN. Nothing.

Dr. PAUL. Good, maybe I'll introduce that bill rather rapidly then. And get your support. We'll have you over here and say, "This is the way to go." Thank you.

Mr. GREENSPAN. I'm not sure I——

Chairman LEACH. Would the gentleman yield briefly?

Dr. PAUL. Yes, I'll be glad to yield.

Mr. GREENSPAN. You carry a vote, Dr. Paul, and I don't.

Dr. PAUL. But you carry some weight down here.

Chairman LEACH. In terms of a modest compromise.

[Laughter.]

Chairman LEACH. There's been a lot of discussion informally on this "know your customer" rule, and I think there is a growing consensus that, as well intended as it certainly was, that there is a view that it might in the final measure undercut, rather than bolster, the banking system if for no other reason because of the perceptions out there that bankers are expected to turn on their customers, as false as that perception may or may not be. It would appear that this is one rule where the general comments coming in

should be looked at very seriously by the regulators with an open mind to revising prior judgments.

Mr. GREENSPAN. I hope we do that all the time, Mr. Chairman.

Dr. PAUL. Mr. Chairman, may I just add I appreciate your comments because I think the banks are really put in the middle because they are dependent on their charters, they're dependent on their credit, they're dependent on their insurance. It's very difficult for them to protect the liberties of the individuals which we are responsible for. And I thank the Chairman.

Chairman LEACH. Yield to the gentleman from New York.

Mr. LAFALCE. Just 15 seconds.

Dr. Greenspan, Tuesday evening when fielding a very, very difficult question from a constituent, my 17-year-old son, who apprised me that in his Government class that day, this "know your customer" regulation issue was discussed. And he asked, "Dad, the teacher wanted to know how come the regulators could promulgate such a crazy regulation?" And I'm wondering if you could give me a written response so that I could provide the class with an explanation?

Mr. GREENSPAN. I would suggest you tell him to wait until the regulators have a chance to do what they are statutorily required to do.

Mr. LAFALCE. OK.

Mr. GREENSPAN. And then we'll all be free to answer that question.

Mr. LAFALCE. All right, and I thank you.

Chairman LEACH. I think the implication is, the hint is that change is in the wind. And I think it's welcome.

Let me see, is it the Democratic side? Yes. The gentlelady, I think you're next up.

Ms. SCHAKOWSKY. Thank you, Mr. Chairman.

Chairman Greenspan, let me introduce myself to you. I'm Jan Schakowsky and I'm a new Member from Illinois. I've been here one month, and every day I experience things that prove to me just how awesome this new job is, but none as dramatic as this, my opportunity to actually ask you questions.

Throughout the many years of debate, I know that there have been considerations of how various parts of the industry are affected, and I know that—I'm sure that consumers and communities were also considered. But I feel it's my particular mission to represent those constituencies and to ask a couple of questions in that regard.

I know that the Woodstock Institute did a study and looked at some banks in Chicago, and found that the five banks that have had the highest number and percentage of small business loans to lower-income communities were banks with assets under a billion dollars. And that bank holding companies with more than $10 billion in assets made a relatively small proportion of their loans in those communities. I'm wondering if we need to be worried about that kind of trend, which was further documented by the Independent Business Association of America that says that small banks with less than $300 million in assets account for close to 50 percent of small business loans under $250,000. Are we at risk of losing this kind of contribution to the community?

Mr. GREENSPAN. I don't think so, Congresswoman. I think that by their very nature, a small bank can only make small loans. It can't obviously compete in the big loan market and they remain profitable and viable largely because big banks can't compete with them for the certain type of personal loan which they have a capacity to engage in. And a small bank will have a loan officer who is probably the vice president or maybe even the president of the bank, he knows everybody in the neighborhood and he knows a good credit risk when he sees one. And so that type of service and the ability to deal with it is inherent in the small bank and it's inherent in the way small business is effectively financed.

If it were to turn out that a lot of the community banks would sort of fade or be absorbed into large institutions, I personally would be concerned. I think that the community banks in this country, not only in Chicago, but around the country are really a major resource of our economy and our society.

From what we can judge, if it turns out that smaller banks are not funding smaller businesses, the larger ones tend to do it because then it becomes a profitable activity for them and they will move in.

We do have a regular survey, which comes out of the National Federation of Independent Business, which they have a question every month with respect to availability of funds, availability of credit generally. And we would be able to spot, I think fairly quickly, that a problem was emerging. At the moment, things seem to be working reasonably well. Our banking system seems to be working reasonably well. And small business is being financed in a particularly useful manner.

What's missing in small business is equity financing. In other words, that's tough to get. But when you're up to a certain size, remember that very small business to a large extent gets financed by relatives or credit cards or other things. You have to actually be an established institution to be able to go to even the smallest banks to get loans. But in my judgment with all of the problems that I think we're all aware of, the system works reasonably well. I don't think that at the moment we have a problem. But should it turn out at some point that we do, I think it would be terribly important for the Congress and the supervisors to take what action is appropriate to make sure that that issue gets addressed.

Ms. SCHAKOWSKY. Can I finish?

Chairman LEACH. Briefly, briefly.

Ms. SCHAKOWSKY. OK. Well, given our need then to monitor that, I'm wondering that since you in the past have had a hesitancy to require banks to collect data regarding race, gender, and other information relative to the record of making small business loans, do you think that you ought to reconsider that position? And that we ought to have that information in order to monitor that carefully?

Mr. GREENSPAN. Well, that issue, as you are probably aware, is under very considerable discussion amongst the supervisory agencies and between the regulatory agencies, the banks, and the community groups. And we'll get it resolved one way or the other.

Ms. SCHAKOWSKY. Thank you.

Chairman LEACH. Mr. Cook.

Mr. COOK. Well, thank you, Mr. Chairman. And I certainly want to thank you, Chairman Greenspan, for being with us to answer some of our questions and provide this testimony on a very, very important matter.

Going to the step two process that you have talked about. You've testified that we should, Congress should go ahead and take step one, which is to eliminate the Glass-Steagall barriers between banking, securities, and insurance. And we should go that way. But you said that we should allow some time to lapse before we really consider step two and that's addressing the banking and commerce issues. H.R. 10 does address that to some extent by giving the Fed the authority to permit commercial activity that is either incidental or complimentary to banking. And I wanted to ask you, in light of your testimony, are you totally comfortable with being charged with the duty to define what those permissible commercial activities would be under H.R. 10?

Mr. GREENSPAN. Well, my personal view is I much prefer that the Congress make those judgments because I think it's important for the supervisory structure not to have a great deal of potentially arbitrary judgments. If the Congress, in whatever form the legislation takes place, requires us to make those judgments, we will do so, whether we're comfortable or not. Obviously, the vaguer the particular statute, the more difficult it is for us. I don't know whether it's an issue of being comfortable or not comfortable. If Congress asks us to do it, we do it.

Mr. COOK. Well, sort of following up on that, to what extent or what are the main ways that the role of the Federal Reserve or the role of the Executive Branch, Treasury, the regulators, how is that role, those roles, what are the main ways that those roles will be changing under H.R. 10?

Mr. GREENSPAN. Well, at the moment, it's changing hardly at all under H.R. 10. The major area where the Treasury perceives as a significant issue is in what H.R. 10 as currently structured would do to the OCC's authority with respect to granting powers not now available now to national banks to the subsidiaries of the banks. That is a disputable power. We at the Federal Reserve in a comment letter have indicated that we read the statute differently. We don't believe that that power exists. But if the OCC and the Treasury believe it exists, and H.R. 10 then prohibits such activity, then they perceive that there is a cutting back of Executive Branch authority. In our judgment, nothing has been cut back because we never believed, at least from a legal point of view, that such authority does exist.

In the broader sense, we consider the operating sub affiliate question of such great significance, that we would be very concerned if that were left to the courts to make a decision on, because on an issue as profoundly important to the structure of finance in the United States in the 21st Century, it is an issue that Congress needs to address and should not be resolved on technical legal grounds through our legal structure. I think that would be most inappropriate, irrespective of whether the reading of existing statutes by the OCC or ourselves is the correct one.

Mr. COOK. And then as a final question what are the consequences if Congress does not pass H.R. 10? Who is it that stands to lose the most?

Mr. GREENSPAN. Well, I think the financial system basically loses the most because there's an inordinately large amount of costs that is expended fruitlessly, in my judgment, and it undercuts some of the efficiencies that our system has. We are, even with all of these restrictions, exceptionally efficient. So I'm not saying that we'll all of sudden run into very serious trouble, but it will be a serious problem. And, indeed, the unitary thrift loophole is not addressed and the issue of so-called Part 5, the OCC's endeavor to put new powers in the subs of the banks, will be adjudicated by the courts rather than the Congress and I think that is, as I said before, an inappropriate way to resolve so crucial an issue.

Mr. COOK. Thank you.

Chairman LEACH. Thank you very much, Mr. Cook.

Mrs. Jones.

Mrs. JONES. Mr. Chairman.

Chairman Greenspan, I too am a new Member of Congress. The name is Stephanie Tubbs Jones. I'm the successor to Lewis Stokes.

As a newcomer to this area, it is my impression that all interests in this area want financial modernization and are willing to accept most any change that would facilitate that modernization. If you take my impression as truth, what role will you, as the Federal Reserve, play in maintaining a level playing field within the financial market? And, second, how do we protect the interests of the consumer?

Mr. GREENSPAN. Well, I think the most protective protection of interests of consumers is primarily to make sure that we have competitive institutions, that we have one or more institutions, one or more branches, the various different types of organizations which vie with one another to try to turn out products. And I think we try to do that. And I think that that's embodied in a lot of the types of supervision and regulation that we are involved in.

So far as the Fed is concerned, we have got a pretty good financial system. It's not perfect. It doesn't do everything everyone would like. But it's not bad. It's very significantly improved over what, for example, existed 30 or 40 years ago. In fact, hugely different from what say existed 50 years ago when you couldn't get mortgage loans, you couldn't get consumer credit. There was just very little interaction between the average consumer and the banking system.

So I would say, in general, that the major areas of concern are those which I think the Congress has got to make judgments on. And having done so, and giving us effectively a charter from which to work, we and the Comptroller and the FDIC endeavor to get together and make certain that the consumer is served in a manner which is low-cost, effective, and hopefully has the type of protection that your colleague was raising earlier about the issue of how do you make sure that consumers are fully informed about what's going on.

Mrs. JONES. OK, I have two more areas and I know I don't have a lot of time. What is the thinking, seeing as every time you speak, everyone seems to listen, Mr. Greenspan, what is your thinking

with regard to the effectiveness and efficiency of the Community Reinvestment Act and the need to continue its implementation?

Mr. GREENSPAN. Well, Congresswoman, I've always argued that it's very important for commercial banks to serve their community and basically not to, as bankers like to say, "Leave money on the table," meaning that there is a significant amount of profitable lending all throughout communities which in the past clearly have not been addressed. And the basic thrust, as we see the Community Investment Act, is to be sure that there is no discrimination in the extension of credit throughout the community. That's what we view as the fundamental issue.

In general, it's worked fairly well. It's got a lot of holes in it, it's got a lot of problems in it, but it's very significantly increased the amount of credit that's available in the communities. And from the looks of the detailed statistics, some of the changes have really been quite profound. I think there's more that has to be done, but everyone is working on it.

Mrs. JONES. I know my last question is going to go over a little bit, Mr. Chairman, if you would permit me that opportunity, I would be much appreciative. My last question is, as a district attorney previously, on behalf of my county, I sued some financial institution investors under what we called the "know your customer" rule. And our allegation was that the investment companies did not adequately notice our agencies of what they were investing in, the long term possibilities or long term detriment to the county standing. And I'm asking, seeing how everyone is asking about this "know your customer" rule, is that the same "know your customer" rule, which these others are speaking to?

Mr. GREENSPAN. The "know your customer" rule that is being discussed here is an extension of a money laundering issue and an endeavor to try to inhibit the types of transactions which have been clearly inappropriate and illegal. I think the issue that you're raising is more a question of the nature of fraud, that it's an issue of appropriate disclosure with respect to any form of transaction because, clearly, if you misrepresent what it is you're selling, that's called fraud and that's illegal. And I think that there are differences here between these two types of concepts, which are related.

Mrs. JONES. I raise that with you because to me it's very important that even if we are talking about the inappropriate drugs, laundering, so forth and so on, that know the customer in the sense that I speak to you is a very important concept, not only for governmental agencies, but for the consumers who we—or at least I—speak for from my particular district. And I would hope that the Reserve is on board with the "know your customer" rule that I'm speaking to.

Mr. GREENSPAN. Let me put it this way. Any bank which doesn't know its customer, isn't going to be around very long. I mean that's how you make money.

Mrs. JONES. I would hope so. Thank you very much for your responses.

Thank you, Mr. Chairman.

Chairman LEACH. And I thank you. And I'm listening to the tail end of your discussion. There is a distinct possibility that the law

you brought your lawsuit under related to the securities industry where they have suitability rules that are also called "know your customer" rules. So it may not be exactly a banking issue, but it could be as well.

Mrs. JONES. But based on what we're talking about, however, financial modernization, it could well become a banking issue, correct? Because we're all going to go to securities, and financial institutions, and everything else coming together.

Chairman LEACH. Without doubt. The only slight distinction was that I think Dr. Paul was referring to a money laundering circumstance rather than an investor circumstance.

Mrs. JONES. Understood.

Chairman LEACH. But you were thoroughly correct. We're in the same ballpark of language.

Mrs. JONES. Thank you.

Chairman LEACH. Mr. Hill.

Mr. HILL. Thank you, Mr. Chairman.

And thank you, Chairman Greenspan, for being here. I always learn a great deal when you're here.

In the past you've made some strong statements with regard to deference to regulators, that is if it's a securities issue in this new world, that should be deferred—the securities—to the SEC. What I want to ask you about is the issue of insurance. Ironically and interestingly, in H.R. 10 we kind of resolve the deference of regulation to the SEC. The battleground is whether or not securities activities will occur in operating subsidiaries. The opposite is true in insurance. Everybody I think agrees that we shouldn't have insurance underwriting in operating subsidiaries. The question is deference of regulation to the State regulators.

I found it interesting you said that the Fed, and the Comptroller, and the FDIC meet to discuss consumer protections. But, as you know, most insurance protections are at the State level. And the insurance commissioners are going to testify later today that H.R. 10, in its current form, substantially preempts, in fact actually totally preempts, their authority to regulate. And then grants them back limited authority, which takes away their authority to safeguard premiums, monitor the financial stability of insurance companies, and assure fair sales and claims processes. Is that an authority that you want to take over?

Mr. GREENSPAN. No.

Mr. HILL. Well, who will then, if we preempt it and don't give that authority back to the States?

Mr. GREENSPAN. Well, let me say this, as I indicated in my prepared remarks, there are invariably an extraordinarily large number of the details which follow on from repeal of Glass-Steagall. In other words, Dr. Paul was raising the question of how about repealing Glass-Steagall. Well, the answer is, yes. But the trouble, unfortunately, is that Glass-Steagall is so intertwined in so many subsequent pieces of legislation that to unwind the whole thing is not an easy task, and this is one of them. I don't think that——

Mr. HILL. No fair coaching.

Mr. GREENSPAN. Well, no, I'm fine. But I'm trying to figure out what the coach is saying.

[Laughter.]

I figure I'm in the red zone or something, and I'm on the wrong team. Let me just see whether my legal counsel can say something. I have a terrific general counsel. Why don't I let him comment? He's better than I am on legal issues.

Chairman LEACH. The committee would recognize Virgil Mattingly for a representation on behalf of the Chairman. Use a separate microphone, Virgil.

Mr. MATTINGLY. Mr. Congressman, I believe H.R. 10 leaves those kinds of decisions to the State regulator. This bill does not take away the authority, in my opinion, of the States to regulate the activities of the insurance company that you——

Mr. HILL. They don't agree with that. They're going to testify later today the opposite of that. Have you consulted with them about that?

Mr. MATTINGLY. We certainly have. We've tried to. I understand that there are some things that the insurance commissioners do today that would not be permissible under H.R. 10. For example, change in control. Right now if someone wants to buy an insurance company, they have to run it by the State. And I think that that would be changed. You would only have to get approval from the Federal Reserve.

Mr. HILL. That's one of the recommended changes.

Mr. MATTINGLY. Yes, but the kinds of things that you talked about, about premiums and claims processes and things like that, they are things that are in the insurance company itself and there's no authority given to the Fed to deal with that.

Mr. HILL. But they are preempted and then given back in a restrictive fashion. Before my time expires, I do have one other question for you, Mr. Chairman, and that is that you have made some strong statements with regard to the President's plan to invest part of Social Security in the stock market. One of the questions that has arisen is, as I understand the President's plan, the proposal is to invest about 85 percent of that in U.S. Treasuries. And actually be marketable and trade in those U.S. Treasuries. I've seen some projections that indicate that that would amount to about $5 trillion at the peak.

The question I want to ask is that the Treasury and the Fed have not always agreed on interest rate strategies in the past in this country. And I presume in the future they wouldn't. Would the Treasury, having the power to trade in $5 trillion in U.S. Treasuries impact the Fed's ability to use Treasury transactions as a mechanism for impacting interest rates and liquidity? Or is that an insignificant amount of money, $5 trillion?

[Laughter.]

Mr. GREENSPAN. By the time it gets to that level, it will be insignificant.

Congressman, at the moment, we have a contingent liability in the Social Security system, which is the unfunded liability of about—depending on what type of interest rates you use—in the area of $10 trillion. And the issue of going effectively to full funding of the Social Security system, which is one of the issues that I raised, would invariably mean at some point that the Social Security Trust Fund would be exceptionally large. However, it is an

issue of relationships. What would happen is that the debt held by the public would be down very substantially. In other words, it's a shift of Treasury debt from the public to the Social Security Trust Fund. Indeed, the President was arguing that, as you may recall, the debt held by the public went down to an extraordinarily low level. Well, what that was was that the debt was moved from the public, where it now exists, into the hands of the Social Security Trust Fund.

So in answer to your question, the answer is no, it would not affect monetary policy. Indeed, the issue of creating additional savings for the purpose of creating new capital assets to fund the retirement of the baby-boomers is something which we very strongly support. And as a consequence of that, we believe the economy would be most efficiently served if there were a very dramatic increase in the national savings.

Mr. HILL. Thank you.

Thank you, Mr. Chairman.

Chairman LEACH. Mr. Meeks.

Mr. MEEKS. Thank you, Mr. Chairman.

Chairman Greenspan, sorry I wasn't here to hear your testimony, but we have other committee meetings going on, but I had a question and I hope that it had not been already covered. Recent studies have shown that bank fees are steadily rising and are at their highest at the biggest banks. And I'm a Member from New York. And many of areas of my district are served by the country's largest banks, such as Chase, and CitiGroup, and Fleet. Annual fees on checking accounts can run as high as $350 to $400 a year. And a number individuals, poor, low-income individuals in my district have come and asked questions in reference to the affordability of checking accounts and banking accounts for them.

So I'm wondering, as banks get bigger through mergers and acquisitions, and I'm concerned that they will be so directed at attracting the bigger customers, that they will find small customers extremely unattractive and give them higher costs and less personal services. What do you see as the trend in service to small customers and how can we make certain that they can afford bank services in the future?

Mr. GREENSPAN. Well, this is a very important question, Mr. Meeks. I think that it's an issue that we have been struggling with for quite a while. It's really an issue which would exist with or without H.R. 10 and whether you pass it or not.

First of all, I think that the major source of personal customer relations comes from the smaller banks or the branches of large banks which try to behave like smaller banks. And to the extent that they are successful, they act like small banks.

It's hard for me to make judgments in individual cases with respect to whether fees are too high or too low. We, as you are probably aware, make an annual survey of all the various different fees and we publish them and try to understand what's going on. It's an ongoing issue. I don't think there's a full solution that will be—we'll never get to the point where we'll say, "Terrific, we've got everything solved." It's an ongoing process to try to make sure that the increased technologies begin to help in the consumer area. And I think that consumer finance, the availability of various different

products, the costs of those products, the services, are all just continuously improving. Perhaps not at the pace that a lot of people would like. And invariably, when you get involved with a lot of technical problems, that there are numbers of things that probably should have been done differently.

But all I can say to you is that the particular concern of the regulators is to make sure that banks maintain appropriate services to their communities.

Chairman LEACH. Well, thank you very much, Mr. Meeks.

Mr. Ose.

Mr. OSE. Thank you, Mr. Chairman. I have to say this is intimidating five weeks into my career here to be speaking to the Chairman of the Federal Reserve. As my colleague suggested, that "When the Chairman of the Fed speaks, people listen." I've heard that somewhere in an advertisement.

Mr. GREENSPAN. Sometimes they understand me. Most of the time, I don't understand myself.

[Laughter.]

Mr. OSE. I have to say I've sat through a number of these hearings and listened to a number of the panels, and for the first time, I think I finally understood somebody today. So my compliments.

My concern is the efficient allocation of capital and the effect H.R. 10 has here. And while I have interest in the value of the subsidy that you referred to earlier with respect to our current system, I have a little bit of a different tack and that is, as you have shared with us, I'm convinced that our system is pretty good right now. I'm concerned about H.R. 10 altering the system between the competing interest of the Fed, and Treasury, and Congress, and the market in such a way as to adversely impact that. If you can reassure me that H.R. 10 doesn't adversely affect that, it would go a long way toward giving me comfort. I don't want to get into a position where we have an inefficient allocation of capital by virtue of hamstringing the Fed.

Mr. GREENSPAN. Congressman, there are a lot of differences that exist between all of the various elements and the people who are coming before you to testify. But I don't think that there is any version that is generally acceptable by parts of the consensus or the whole of the consensus, which in any way significantly alters the underlying structure to the detriment of the system. I'm sure that there are individual provisions which are not all that helpful. But the only thing, in my judgment, which would significantly alter the whole balance of the system is moving from the holding company structure to operating subs. That's the only thing large enough in any of the provisions in H.R. 10 to have a really meaningful effect.

Mr. OSE. Thank you.

Chairman LEACH. Thank you, Mr. Ose.

Mrs. Biggert.

Mrs. BIGGERT. Thank you, Mr. Chairman. We seem to have a shortage of mikes around here. At least I'm not in the kid's table.

[Laughter.]

Sorry, to my colleague.

Chairman Greenspan, you stated in your testimony that dramatic advances in computer and telecommunication technologies of the past decade have so significantly altered the structure of domestic and global finance as to render our existing modes of supervision and regulation of finance increasingly obsolescent. How does this impact the U.S. position of financial leadership with regard to other countries? And are we in danger of increased competition for leadership by the unified European market?

Mr. GREENSPAN. There's no doubt that emergence of a single currency amongst the eleven so-called "Euro-land States" will create a currency which is more competitive against the dollar than the predecessor currencies of the euro. I happen to think that's good, not bad. I think that competition is always useful even though we don't like it. At the end of the day, it turns out to be quite helpful. So I should think that for a number of technical reasons, which have to do with eliminating some of the risks, such as exchange rate risks that are involved, we have different currencies and when you put them into one, you get a more efficient, more liquid, more effective currency; that is going to mean, as it already has, that a substantial amount of bonds that are sold in the international markets are denominated in the euro rather than dollars. And I don't know how long that is going to last, but what we clearly see on the horizon is a much greater degree of competition between the European currencies generally and the dollar. And I think we'll all benefit from that.

Mrs. BIGGERT. Thank you. Then how does the financial modernization alter or improve our status with the international realm?

Mr. GREENSPAN. If we maintain the holding company structure, it should not. In other words, it should basically enhance the already superior capability of the American financial system to compete with all other financial systems around the world. Provided that we can contain the subsidies which distort the allocation of capital and can undermine how we produce financial services, I see no reason why the United States should not continue as a very effective supplier of financial services, both in the United States and abroad.

Mrs. BIGGERT. Thank you very much.

Thank you, Mr. Chairman.

Chairman LEACH. Thank you, Mrs. Biggert.

Mr. Green.

Mr. GREEN. Thank you, Mr. Chairman. And this is the kid's table. As you might have been able to gather, you are at the freshmen portion of the questioning, and my questions will reflect that. My questions I think are broader in scope, some of the things perhaps underlying some of the other questions and your comments.

You stated publicly, orally and in writing, that you don't believe H.R. 10 will diminish the Executive Branch's regulatory ability. Could you, for those of us who are new to this process, briefly outline what you see as the role of the Fed today versus how it would be under H.R. 10, assuming H.R. 10 becomes law?

Mr. GREENSPAN. The role of the Fed net on balance changes very little. We would obtain increased supervision of financial services holding companies when a securities firm, for example, buys a

large bank or something of that nature. So that the scope would be broader, but the depth would be much less, because in H.R. 10 there are very material reductions in the authority of the Federal Reserve to supervise especially the new powers. We call that "Fed-light," meaning that we cannot do a number of things that we used to do and which we think are more reflections of the old 19th Century philosophy. And so H.R. 10, as it now is drafted, would probably net, on balance, very little to the Fed's authority, but it would spread us over a broader range, but reduce the aggregate amount of supervision we are doing.

And, frankly, our judgment is that as we move into the first part of the 21st Century, the old-fashioned techniques of supervision, which had examiners going into banks, looking at documents, looking at loan reports, are gradually fading as an effective means of doing anything. What we are trying increasingly to do is to have sort of broad oversight and recognize that the primary safety and soundness of financial institutions really is the result of individual banks or other financial institutions examining and understanding the counter-parties to whom they lend. It's their shareholders money which is at risk. And that is a very sobering environment in which to extend funds.

What we are doing now increasingly, and probably will be doing far more in the future, is to oversee that process rather than second guess a lot of different individual documents or individual loans, which is what we used to do in the past.

Mr. GREEN. Let me ask the same question as it pertains to the Executive Branch. How do you see that role changing and broadening?

Mr. GREENSPAN. Well, the actual role of the Comptroller of the Currency and Office of Thrift Supervision doesn't change. As I mentioned earlier, the basic issue which the Executive Branch perceives as a loss of its authority is an issue under dispute. It's whether in fact they have an authority now to effectively create powers for subsidiaries of banks under existing statutes. They think they do, the Comptroller thinks they do. We think they do not. The courts ultimately, of course, will decide unless the Congress preempts the decision.

So our view is that since we don't believe they have that authority, they're losing nothing. And in all other respects, there's literally no change of material importance. There's some pluses and some minuses, but that's not what concerns me. And there's some pluses and minuses, I might add, also for ourselves, but they're all very small technical issues of no great importance. The crucial question really gets down to whether or not you interpret the loss of an authority, which they have not yet invoked and tested in the courts, is a loss or not. And that is, I guess, a judgment which the courts will have to make or the Congress will effectively make a judgment on in presumably the final version of H.R. 10.

Mr. GREEN. Thank you, Chairman Greenspan.

Thank you, Mr. Chairman.

Chairman LEACH. Thank you, Mr. Green.

Mr. Inslee.

Mr. INSLEE. Thank you, Mr. Chairman. Listening to your testimony, I recalled the book by Leonard Garment, an autobiography,

and he made reference to a fellow named Alan Greenspan who played in a jazz band with him. And I would like to know if you're that Alan Greenspan? And, if so, what instrument did you play?

Mr. GREENSPAN. Yes, I played saxophone, clarinet, and bass clarinet. And if I were a lot better, I probably would still be doing that at the moment.

[Laughter.]

Mr. INSLEE. Well, I know there are those who believe your RIFs on the U.S. economy have deserved a little praise, so I'll add my voice to that choir.

Your comments about your concern for the distorting impact of subsidization through the op-subs, as I understand it, are real interesting to me. And I would like to ask you is there any kind of analogous economic situation that you could describe that I could talk to my constituents about? Is there some analogous part of the economy that folks may understand back on Main Street, something that folks who have not been sitting through these hearings for six hours might understand?

Mr. GREENSPAN. It's tough, largely because it's a very technical issue which gets to the question of the structure of the total financial system. And every time you try to simplify something like that, you often get it wrong.

Let me take a shot at it and drop you a note to see if I can get something which will capture that. Frankly, that's the toughest question I've got all day. It's a very tough thing to do without doing violence to reality. Let me see if I can take a shot at it, and I'll drop you a note.

Mr. INSLEE. Thanks very much.

Thank you, Mr. Chairman.

Chairman LEACH. Thank you, Mr. Inslee.

Paul, are you ready or do you want me to go to Mr. Ryan?

Mr. RYAN. Thank you, Mr. Chairman. I, too, have heard about your musical talents. I was a fan of the unedited Alan Greenspan when you wrote your articles in *The Objectivist*. I know you can't speak as frankly these days, but I would like to see if you could highlight a point in your testimony where you said that the European system was inferior to our system with respect to the subsidy exposure and the distortion in the marketplace? Could you in more detail highlight why that is an inferior system and why that taxpayer exposure is detrimental to our system?

Mr. GREENSPAN. Well, there are basically two reasons. First of all, the system is subsidized in Europe, which creates a mis-allocation of capital and invariably reduces the capital efficiency of the system. But that's got nothing to do with the structure because that would occur even if they had a holding company system. The problem basically is, as best we can judge having experienced this over the years, is that what a universal bank does when it has all the various elements inside the bank, is that losses in one segment of the bank affect every other aspect of the institution. And there is a tendency to what we call cross-subsidization, where you put funds from one part of the institution into another, and that means that if you have part of the organization, which is doing exceptionally poorly, you don't tend to scrap it, you don't tend to unwind it.

In a holding company structure, if you have an affiliate which is doing poorly, it is not connected either legally or otherwise necessarily to the rest of thing and it's very easy to unwind it. And they do that.

And so what has happened historically is it's turned out that the rates of return and the efficiencies that we see in these so-called "universal banks" have not been good. They clearly have not been up to the American model. That is, we have clearly out-competed them. And I think a goodly part of it is the structure issue.

Mr. RYAN. So when you hear the argument that in order to compete on an even footing with universal foreign banks, you don't buy into the argument that we need the kinds of cross-subsidization in order to fairly compete with them? You're saying that the contrary is the case? That we are more nimble and more efficient with the holding company structure versus this inferior European model?

Mr. GREENSPAN. Exactly.

Mr. RYAN. OK. Thank you very much. Thank you.

Chairman LEACH. Thank you very much, Paul.

Mr. Green—excuse me, Mr. Toomey.

Mr. TOOMEY. Thank you, Mr. Chairman.

Chairman Greenspan, a couple of questions. I would like to get back briefly to the issue of op-subs if I could. I know we've asked a lot of questions about this. As I understand it, your primary objection to allowing principal activities to occur at the op-sub level is the fact that they enjoy the benefit of a subsidy from the bank and, therefore, that creates an unfair competitive advantage and, thus, a misallocation of capital. But you've raised an additional concern. And that additional concern is one of perhaps systemic risk or at least risk to the individual bank in that in an event of a catastrophic capital loss in an operating subsidiary that that would threaten the bank.

My question for you is how is that such a catastrophic loss of capital in the operating subsidiary poses a greater threat to the bank than that kind of catastrophic loss in an affiliate of the bank?

Mr. GREENSPAN. The loss to an affiliate is not consolidated into the bank itself. It's into the holding company where there is no safety net structure. The loss in a subsidiary of a bank is automatically consolidated into the bank itself. And so you have two different types of effects. Because you have deposit insurance and the safety net generally in the bank, you have potentially a threat to the FDIC. The loss in an affiliate of the holding company is insulated from the bank and is charged only against the consolidated system. I don't know if that answers the question, addresses the question you're trying to get at.

Mr. TOOMEY. If I can ask a follow-up. It strikes me that the answer refers to the way financial reporting occurs, which I acknowledge. But does that change the fundamental economics of where the loss is?

Mr. GREENSPAN. No, it's more than reporting, because it is the form of the legal ownership. As a practical matter, if commercial banks treated the subsidiary of a bank as a limited corporation which could be essentially cut off, then there would be no distinction in this regard. The difference essentially occurs because of the fact that the funding capability of a commercial bank is usually

viewed in terms of the total system because no bank would allow its' sub to fail because in doing so, you would undercut the viability of the total consolidated bank and the cost of funding of the bank itself. It's not a legal issue. It is a banking issue. It's the way banks tend to operate.

Mr. TOOMEY. And a bank would perceive its' ability to fund to be less effective by the failure of an affiliate?

Mr. GREENSPAN. Correct. The funders of the bank may be concerned about an affiliate of the holding company being in difficulty, but its effect on the funding of the bank is very small.

Mr. TOOMEY. OK. Thank you. One other unrelated question. When we look at one of the primary objectives of H.R. 10 is to allow different kinds of financial institutions to offer different financial services with fewer obstacles, fewer impediments imposed by the regulatory structure. To the extent that some version of H.R. 10 succeeds in accomplishing that, would you feel safe in saying that this will almost certainly benefit consumers in the long-run by lowering the cost to these institutions in providing these services?

Mr. GREENSPAN. Oh, most certainly. In fact, at the end of the day, the whole purpose of the capitalist market system is effectively to help consumers.

Mr. TOOMEY. Thank you very much.

Chairman LEACH. Thank you very much. We have one more. Did you have a quick one?

Mr. Sweeney.

Mr. SWEENEY. Thank you, Mr. Chairman. And I apologize for my tardiness to both you and to our guest. I had to chair a competing hearing in a different room, and so I apologize if I've missed some of your testimony. As I understand it, in earlier statements, you had said that if we failed to pass our H.R. 10, or some form of H.R. 10, that it would be pretty much left to the courts and regulators to determine where we go from here and what the future is. In light of that, and knowing that the op-sub issue is such a key point of debate, as it relates to passage of this bill, I have a very simple question and that is would you prefer to forego financial modernization rather than enacting a bill that permitted an op-sub?

Mr. GREENSPAN. I would, Congressman.

Mr. SWEENEY. There's some who—let's assume that we are able to reach some agreements on that—there are some who advocate providing firms with the choice of regulatory structure, whether it be op-subs or the holding companies, could you give me a sense of that notion of choice and where you are? I know you probably have covered points of this, but I would like to get——

Mr. GREENSPAN. I didn't quite get the question, try me again.

Mr. SWEENEY. There are some who have proposed the idea that we develop a choice between the op-sub process and regulatory process and holding companies, what's your sense of that?

Mr. GREENSPAN. Congressman, if there were no subsidy in the bank, I see absolutely no reason why Government should be involved in making judgments as to whether an institution should put something in the subsidiary of one part of the organization or in another. The issue is solely the question of that this is not a choice in a sense that any profit maximizing banker does not con-

sider that there is a choice between a holding company affiliate and a sub of a bank because one has low cost and the other has high cost, choose. I mean if he chooses the wrong one, he should be fired.

Mr. SWEENEY. Thank you. Mr. Chairman, I yield my time.

Chairman LEACH. Thank you.

Mr. LaFalce.

Mr. LAFALCE. Thank you, Mr. Chairman.

Chairman Greenspan, I very much look forward to sitting down with you, Secretary Rubin, Chairman Leach, and other key parties in order to further discuss this issue because it obviously is a principal issue in contention. I also don't want to take a second round, but I have to tell you that I've been a bit confused because in some instances you refer to a subsidy as not a safety and soundness issue, but then when you're talking about loss to the insurance fund, it sounds like safety and soundness. When you're talking about the Asian difficulties, it sounds like safety and soundness as opposed to subsidy. And so you have confused me on that. And if it a loss to the insurance fund that's your concern, then I am curious why the chairman of the insurance fund, and all the past living chairmen of the insurance funds, think that they can deal with potential losses much better through an operating subsidiary? If it is a subsidy, I would like to see the papers which define the subsidy and quantify the subsidy because there's some debate. And you I think have said that that's one of the most difficult questions, trying to put the subsidy. If the subsidy is the insurance, is this not controllable through the concept that exists of risk-based premiums?

Mr. GREENSPAN. No, I understand why there's a confusion and I apologize for creating that. There are two different types of safety and soundness questions here. One is the issue of the system as a whole. Let me leave aside the question as to whether, in fact, there is any risk in the issue of putting powers into the sub of a bank. In fact, my original view of that was that that wasn't a big issue. And, indeed, my essential argument really rested almost wholly on the question of the issue of moving subsidized equity capital from a bank to a subsidiary and the impact of doing that on the financial structure because of the distortion of capital.

There is a secondary question, which is really unrelated to that issue, and that's the question as to whether, in fact, not the system as a whole is being undercut by the issue of the subsidy, but whether the powers put into the individual sub of the bank potentially undercuts the viability of the bank itself. You can answer, "Yes," to the first and "No," to the second. Or "No," and "Yes." Those are not necessarily related.

And I was saying, I don't remember whether or not I mentioned this when you were here, Mr. LaFalce, but the issue which changed my mind about the second question was something I had known about but hadn't thought about it, and my colleagues brought it to my attention; and the more I thought about it, the more I realized that they are right. And that is the question of when you are in a financial crisis, you can lose a lot of money very quickly. And there was a subsidiary of a bank, First Options was a subsidiary of Continental Illinois, and it in one day, that was October the

19th, 1987, I think lost everything. That was charged against the bank. There was nothing the regulators could do. And, indeed, there was a problem of in fact activities which Continental had done with respect to that sub on that day, which we had lots of questions about. What I'm saying is——

Mr. LAFALCE. Was that a State-chartered bank?

Mr. GREENSPAN. I'm sorry?

Mr. LAFALCE. Was that a State-chartered bank?

Mr. GREENSPAN. A national bank. That experience reflects the fact that with all of the controls you can put on an individual bank, in a crisis environment it is quite feasible for the sub to be wiped out before any of the controls can be employed. Now I say that that is an issue relevant to the safety and soundness of the bank, it's not an issue of systemic risks. Those are two separate things, and I apologize because I think you're quite right. I tended not to draw the distinctions as cleanly as I should have.

Mr. LAFALCE. And the activities of that op-sub were activities that could have been performed within the bank itself?

Mr. GREENSPAN. As far as I understand it. In fact, that legally had to be the case, yes.

Mr. LAFALCE. Thank you.

Chairman LEACH. Thank you, Mr. LaFalce. And we want to thank you, sir. And let me express some information——

Mrs. JONES. Mr. Chairman.

Chairman LEACH. Yes?

Mrs. JONES. Could I just ask one last question? I promise it will be short.

Chairman LEACH. If it's very brief, Mrs. Jones.

Mrs. JONES. It's real short. It's real short. Thank you, Mr. Chairman.

Chairman Greenspan, in the law we talk about creating legal fictions in order to accomplish a goal. Are you suggesting that within the world because we have not had financial modernization that they are—or bankers, or financial institutions, are creating financial fictions in order to accomplish what they want to accomplish under H.R. 10 or financial or legal fiction?

Mr. GREENSPAN. I'm not sure I know how to answer that. Can you give me an example so I can?

Mrs. JONES. For example, you might have a corporation that wants to accomplish something and because they cannot accomplish something under one corporate structure, they create a separate corporate structure in order to accomplish the same goal with the same incorporators. Is that what is happening in the financial world in order to do what they can't do without H.R. 10?

Mr. GREENSPAN. Well, I think they do that all the time, Congresswoman. I mean that's standard procedure, which I think gives considerable business to lawyers.

[Laughter.]

Mrs. JONES. So by passing H.R. 10, we get over the financial fiction?

Mr. GREENSPAN. I would think you rationalize the system in a manner which would be helpful to the effectiveness of the total structure, yes.

Mrs. JONES. Thank you, Mr. Chairman.

Chairman LEACH. Thank you, Mrs. Jones.

Mr. Royce.

Mr. ROYCE. Well, thank you, Mr. Chairman. I'm sorry I missed the meeting. I was chairing another subcommittee meeting, but I understand that all my questions have been answered. So I'll find those answers in the record. Thank you, Mr. Chairman.

Chairman LEACH. Thank you, Mr. Royce. Let me just thank the Chairman and explain that since this hearing has begun, the market has gone up 100 points.

[Laughter.]

Now there are two explanations for it. And I think only two. One is the possibility that support for H.R. 10 is extraordinary.

[Laughter.]

The other possible explanation is that the market is awfully persuaded that the Chairman of the Federal Reserve Board is capable not only of answering multiple choice questions but devising them himself.

Mr. LAFALCE. There's an alternative, Mr. Chairman. I understand that Chairman Greenspan gave his wife for Valentine's Day a little bull rather than a bear.

[Laughter.]

Mr. ROYCE. Mr. Chairman, I just want to thank you for leaking the advance copy of the testimony here.

Chairman LEACH. Well, in any regard, the committee stands bullishly desirous of continuing, but asking Mr. Greenspan or suggesting to Mr. Greenspan he can step down, and thanking him despite the jet lag for spending so much time with us. Thank you.

Mr. GREENSPAN. Thank you very much, Mr. Chairman.

Chairman LEACH. Our second panel is composed of Mr. Thomas J. Curry, Commissioner of Banks for the Commonwealth of Massachusetts, on behalf of the Conference of State Bank Supervisors; Mr. Thomas E. Geyer, Commissioner of the Ohio Division of Securities, on behalf of the North American Securities Administrators Association; Mr. George M. Reider, Jr., who is the Connecticut Commissioner of Insurance, and President of the National Association of Insurance Commissioners.

I thank each of you and we'll proceed in the order in which you've been introduced unless you've made an arrangement to the contrary.

Mr. Curry, please proceed.

STATEMENT OF THOMAS J. CURRY, COMMISSIONER OF BANKS, THE COMMONWEALTH OF MASSACHUSETTS, ON BEHALF OF THE CONFERENCE OF STATE BANK SUPERVISORS

Mr. CURRY. Good morning, Chairman Leach, Representative LaFalce, and Members of the committee. I'm Tom Curry, the Massachusetts Commissioner of Banks. I'm also Vice Chairman of the Conference of State Bank Supervisors and a member of FFIEC State Liaison Committee. I'm very pleased to be here today.

Mr. Chairman and Representative LaFalce, we applaud your longstanding support for the dual banking system and greatly ap-

preciate this committee's continuing efforts to defeat State bank examination fees. We also commend your efforts to modernize our financial system.

CSBS supports expanded bank activities that provide a broader range of choices to the consumer, enhance competition, and do not jeopardize safety and soundness. CSBS believes that any changes to our current system must preserve safety, soundness, and public confidence.

Regulation should not drive new products and services or new delivery systems, rather, the market should drive changes in the industry and regulation in a market-driven environment can promote safe and sound behavior by supplying incentives for well-managed institutions.

Many provisions in H.R. 10 advance these goals. Under our dual system of banking, States and the Federal Government independently charter and regulate financial institutions. Over 70 percent of all banks are State-chartered. These State-chartered banks have long conducted many non-banking activities, as authorized by the State legislatures, and have done so within the bounds of safety and soundness.

State initiatives have spurred most advances in U.S. bank products and services. And, for example, the NOW account came out of my own State of Massachusetts. When new activities emerge one State at a time, systemic risk is minimized.

When changing Federal law, we must preserve the State's ability to experiment independently with new products and services, new structures, and new delivery methods.

One concern we have with H.R. 10 is its rollback of State-chartered banks' securities underwriting activities. State-chartered banks should continue to have the option of conducting securities activities in bank subsidiaries, as currently allowed, as well as holding company affiliates.

As we all learned too well during the savings and loan crisis of the 1980's, the key to expanding powers is effective supervision. Therefore, our State and Federal banking agencies must supervise any banking organization that engages in additional activities from the top down and from the bottom up.

CSBS is pleased that H.R. 10 recognizes this regulatory principle. We believe that the Federal Reserve, with its joint responsibilities of protecting bank safety and soundness and promoting economic stability and growth, is well-suited to serve as the umbrella regulator to the new qualified bank holding companies.

We are not comfortable with the functional regulation model that disregards the banking regulator's responsibilities for the overall safety and soundness of the organization. However, functional regulation may play an important role especially in the area of consumer protection.

Successful functional regulation requires the cooperation and coordination of all regulators involved. Towards this goal, we have created joint task forces with the National Association of Insurance Commissioners and the North American Securities Association. These task forces are intended to facilitate data information sharing and the coordination of supervision. We also strongly support

H.R. 10's provision to repeal Section 3(f) of the Bank Holding Company Act, as it is no longer needed.

CSBS does have reservations about the course that financial modernization will take without congressional action. Congress has an obligation to create an appropriate regulatory structure for the new financial organization already emerging in the marketplace. However, we believe that any legislative proposal addressing concerns about the Thrift Charter should be forward-looking and enable competitive opportunities for all financial institutions.

Additionally, we strongly support the provision in H.R. 10 calling for publication in the Federal Register of any preemption of State law by the Office of Thrift Supervision. This provision, which does not in any way affect an agency's preemption authority, is clearly consistent with Congress' continuing pursuit of a Government in the sunshine.

State bank supervisors are an integral part of the Nation's banking system. Preserving the authority of each State to decide the bank structure, product, and services that best suit its business needs, strengthens the entire system. H.R. 10 is a good beginning for the modernization of our Federal Banking System. It recognizes that the lines between traditional banking and other financial services are disappearing. It provides for a system of comprehensive oversight.

We look forward to working with you to adapt our banking system for the 21st Century. I would be happy to answer any questions that you may have.

[The prepared statement of Thomas J. Curry can be found on page 494 in the appendix.]

Chairman LEACH. Thank you, Mr. Curry.

Mr. Geyer.

STATEMENT OF THOMAS E. GEYER, COMMISSIONER OF OHIO DIVISION OF SECURITIES, ON BEHALF OF NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC.

Mr. GEYER. Thank you, Mr. Chairman. I am Tom Geyer, the commissioner of the Ohio Division of Securities, and I am honored to have the opportunity to discuss some issues regarding H.R. 10 on behalf of the North American Securities Administrators Association, known by the acronym NASAA.

We applaud your determination to hold hearings early in the session to make financial services modernization a priority, and we fully concur with the testimony you heard yesterday indicating, first, that now is the time for comprehensive, congressionally directed, financial service modernization, and, second, that such modernization must be based on true functional regulation.

Mr. Chairman, I urge you and the committee to keep in mind that sweeping financial services reform will profoundly affect millions of individual investors across the United States. While I testify today on behalf of NASAA, I also represent individual investors, like my wife who invests in her law firm's 401(K) plan; my father, a schoolteacher who invests through his individual retirement account; my Aunt Pam, a single mother of two who invests to provide for college expenses, and my grandfather, a retired veterinarian who seeks to preserve his retirement income.

We have moved from a Nation of savers to a Nation of investors as witnessed by the fact that Americans now put more money in mutual funds than they do in insured bank deposits. So, as we debate financial services modernization, NASAA's main message is that we support and advocate reform based on true functional regulation, which means that oversight must be identical, not simply comparable or similar. In other words, there must be a level playing field where securities firms, banks, insurance companies, and mutual funds are subject to the same complimentary State/Federal securities regulatory system.

In this regard, we strongly echo the words that the Securities Industry Association expressed to you yesterday, and I quote, "The SEC, the Securities self-regulatory organization, and the State securities agencies should regulate securities activities regardless of what entities perform those services." This position is based on the premise that investors must receive the same disclosures and enjoy the same protections regardless of where securities products are purchased. Similarly, the people who sell securities products must be subject to the same licensing qualifications and oversight.

Our securities industry has thrived as a result of this shared oversight system, and I respectfully suggest that we have the most successful securities markets in the world because of this complimentary State/Federal system, not in spite of it. Consequently, we believe that true functional regulation is a key ingredient of any reform effort.

H.R. 10 would fundamentally impact this system. Specifically, Section 104(b) calls for wholesale preemption of State securities laws. We believe that this is inconsistent with functional regulation. One aspect of this regulation will be to eliminate State licensure with individual stockbrokers with respect to bank activity.

On the issue of State licensing, a recent SEC report stated, "Licensing authority enables States to identify and prevent those individuals who present a serious risk to their citizens from entering or remaining in the industry. Anti-fraud authority by itself does not give regulators the tools they need to detect and deter sales practice abuse and fraud."

The Federal laws that are left in place after preemption of State law are further limited by provisions in Title II which exempt from Federal law significant amounts of bank securities activity that will occur on a daily basis between banks and retail investors. We fear that dysfunctional regulation rather than functional regulation will result. Under the proposed act, financial service providers would be operating on an unlevel playing field and the degree of investor protection would depend on where the securities transactions took place.

Briefly, please allow me to read excerpts from a handwritten letter recently received by the Ohio Division of Securities, and I have changed the names to preserve the confidentiality. "On March 6, 1998, I went to X Bank with over $20,000 in $100 bills I had saved for a few years. I told the bank representative I just wanted it in the bank. Then she started pushing this Y stock on me. She asked me to sign a few times, and that was that. I opened one yesterday and showed it to my dad; he said I got ripped. I wonder if you can help me with this. I wasn't wise to the stock business."

The materials accompanying this letter reveal that this gentleman is unemployed and receives $6,000 annually from Medicare. The bank representative put over $10,000 into a growth and income mutual fund, which is an appropriate investment for many people, but clearly unsuitable for this individual. In fact, the account statements showed that the mutual fund had lost almost 15 percent of its value during the first six months.

These are the stories that we see everyday on the front line of securities regulation, and under the proposed structure of H.R. 10, these are the types of transactions that would fall outside the existing securities framework.

In conclusion, again, we believe that the modernization effort must be based on functional regulation. I do want to reiterate our strong support for congressionally directed financial services reform, and as the process moves forward, we urge you to give additional thought to these issues: the absolute need to base the reform on true functional regulation, the far-reaching effects of preempting State laws, and the bill's enormous impact on individual investors. We stand ready to work with you with any technical assistance you may need.

Again, I appreciate the opportunity to testify and would respectfully request that my written testimony be included in the record. Thank you.

[The prepared statement of Thomas E. Geyer can be found on page 513 in the appendix.]

Chairman LEACH. Thank you.

Mr. Reider.

STATEMENT OF GEORGE M. REIDER, JR., CONNECTICUT COMMISSIONER OF INSURANCE AND PRESIDENT, NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

Mr. REIDER. Thank you. My name is George Reider. I serve as Commissioner of Insurance in Connecticut and President of the NAIC. I am testifying today on behalf of the NAIC's Special Committee on Financial Services Modernization.

Before I begin, I would like to thank you, Chairman Leach, and the committee for the invitation to testify. We very much appreciate the hard work you are doing on legislation to modernize Federal laws dealing with financial services integration.

While we strongly support your goal and want to work with you in every way possible, we must state up front that H.R. 10 is seriously flawed in a number of areas with respect to insurance regulation. I will briefly explain the NAIC's position by making four key points.

My first point: as presently written, H.R. 10 will harm insurance consumers and insurance regulations in the United States. In the name of giving banks and insurers a level playing field, the bill directly preempts large chunks of the general consumer protection authority given to us by State legislatures. These important laws do not discriminate against banks. They are applied equally across the board to every company that chooses to offer insurance products to the public.

For example, my home State of Connecticut was involved last year in the regulatory approval process for the merger between

Travelers Insurance Company and Citibank. As commissioner, I reviewed the proposed business plan and a complete filing of financial and operating data before making a final decision that the merger should be approved. I met my responsibility to fully review the merger on behalf of the public, and the matter was handled expeditiously with no complaints from the companies making the applications. Under H.R. 10, however, I would be automatically prevented from conducting a proper regulatory review of such a large and influential merger affecting insurance consumers in my State.

On a broader level, there is a chart attached to our prepared statement showing the preemption problem with H.R. 10. That chart identifies more than 50 NAIC model laws that are the basis for most State statutes covering such critical areas as examination, audit, reinsurance, capitalization, valuation, investments, liquidations, guarantee funds, agency licensing, and holding company supervision. Nearly all of them will be subject to preemption if H.R. 10 is not amended to preserve State authority.

My second point: H.R. 10 threatens the substantial progress now being made by State insurance regulators using our existing authority. State insurance departments are working through the NAIC to accomplish much greater uniformity and efficiency among themselves. New technology is being used to allow constant communication and updated data sharing on key licensing, enforcement, and rate filing requirements. State departments are also signing reciprocity agreements dealing with agent licenses to eliminate needless redundancy.

The NAIC is currently working with the Office of Thrift Supervision, the Comptroller of the Currency, and the Conference of State Bank Supervisors to develop and implement mutual cooperation agreements covering regulatory and enforcement matters. We have also conducted a series of meetings with OTS and the Federal Reserve Board to educate each other about specific supervision methods used to monitor and control the industry under our respective jurisdictions. These efforts will continue during 1999; in fact, they will increase.

My third point: State governments ought to be equal partners with the Federal Government in assuring that financial integration of banking, insurance, and security products is handled prudently. We are the primary regulators of insurance in the United States. If the Federal Government prevents the States from supervising insurance adequately, this vital consumer protection function will not get done at all. Most importantly, the cost of failing to supervise insurance properly will fall on State governments and their citizens through State-guarantee programs and unpaid claims. There is no federally sponsored guarantee program to cover insolvency or to reimburse consumers for their insurance losses.

We ask that Congress be very careful about the impact on States when rewriting Federal banking laws. Overly broad language and imprecise drafting can easily undermine the safety and soundness of laws that apply to all insurance providers, not just banks.

My last point: The insurance regulation problems in H.R. 10 can be fixed using a few straightforward amendments prepared by the NAIC. Furthermore, the bill can be fixed without compromising the consumer and the business benefits which the bill sponsors hope to

achieve. Today, we pledge our strong commitment and assistance to you to do just that.

In conclusion, preemption of State consumer protection statutes by changing Federal banking laws will inject needless confusion into the insurance regulatory system at the very least. The extent of insurance authority, which is now pretty clear, will surely be questioned, not only by banks and their affiliates, but possibly even by traditional insurers which have been complied with the present laws for many years.

As insurance regulators, we take pride in our work, our record of accomplishments, and our ongoing efforts to keep abreast of changes in the marketplace. Yet, H.R. 10 seriously threatens our ability to do the job expected of us by our consumers. It makes no sense to undercut a State regulatory system that has worked very well. Please fix H.R. 10 to preserve State insurance authority over insurance providers including banks as financial modernization moves forward, and, again, we stand ready to work with you in every possible way. Thank you.

[The prepared statement of George M. Reider Jr. can be found on page 527 in the appendix.]

Chairman LEACH. Well, I thank you. As you know, there are an awful lot of compromises in this bill. There are compromises between and within industrial groups. There are compromises between and within regulatory structures. All I can say is the general thrust of this bill is toward functional regulation. There are judgments that each of the regulators wish would go a little bit more their direction, and that is national versus Federal; that is intergroup versus other group, and I think that what we have heard today are some of the concerns coming from a very specific direction. But I will tell you the general thrust is toward functional regulation and preserving a significant role for the States.

I have one question for Mr. Curry. H.R. 10 contains a provision that the Office of Thrift Supervision will be required to publish notice and comment when preempting State laws with regard to consumer protection. The Trade Association for Unitary Thrifts testified yesterday, and I quote, "This additional procedure would have a chilling effect on the Federal thrift operations and for the further development of a nationally competitive financial service marketplace in increased costs and reduced convenience for consumers." What would your reaction be to that perspective?

Mr. CURRY. I think that comment probably goes, Mr. Chairman, to whether the whole concept of preemption should be curtailed. That is not our position; we fully respect Congress' ability to legislate and regulate in this entire field. What we are simply saying—and I can say this from my own personal experience—that it is very frustrating as a State official to learn, usually through a third party, that the OTS has taken interpretive action to their preemption powers to actually strike down or limit the application of a State law to a particular institution and to all OTS charter institutions. What we are simply saying is that by supporting the public notice and comment division is that it benefits both the State regulators and the OTS that there is an opportunity for State regulators, in particular, to provide an official view of what the State law means or has been enforced to mean at the State level rather

than having this done really without any input and the States to have to deal with the final result.

Chairman LEACH. But isn't it true that the other Federal regulator you deal with in a comparable basis, the Comptroller's office, has this procedure, and so OTS has a privileged procedure relative to the Comptroller's office?

Mr. CURRY. That is correct, and Riegle-Neal required the OCC to engage in the publication in the Federal Register. Also, that was actually useful to the Massachusetts legislature when it was debating the repealing or anti-affiliation laws with insurance sales that we were able to see at least what the issues were legally in terms of whether some of the provisions being considered by the legislature might be subject to a preemption challenge. That helped our legislature invariably in deciding whether or not to pursue a particular protection or other licensing requirement when they opened up bank insurance sales.

Chairman LEACH. I am going to turn to Mrs. Roukema. Before doing it, I would like you to know we have about two or three minutes before we have to recess for a vote.

Mrs. ROUKEMA. Mr. Chairman, I thank you, and I don't want to unduly delay this panel, and we recognize that we have to be over there, so I am just going to say—with apologies to the fact that I wasn't here initially for Mr. Curry and most of Mr. Geyer's statements—I will say that I am particularly sensitive to this question about the SEC and Mr. Levitt's concerns. I will go over your testimony, and I will go back over with staff and with you, Mr. Chairman, the history of how we have arrived at some, I believe, far more tenable position with our bill, but that was reversed in the Senate or we went through the process, and it was not sustained.

But I won't take the time today; I will look into that and see—I certainly don't want it to be dysfunctional regulation, but there has got to be a way of dealing with this in the interest of safety and soundness and true functional regulation, but I won't hold up the group. I don't have with precision a question for either of the people here, but I think we will be able to accommodate it to your concerns.

Chairman LEACH. Mrs. Kelly.

Mrs. KELLY. Mr. Chairman, I do have some very precise questions that I would like to ask the panel, and time is short. May I run through a few of them quickly and then, perhaps——

Chairman LEACH. You may do that or do you want us to return? You tell me what is best for your timeframe.

Mrs. KELLY. I would like to ask my questions.

Chairman LEACH. Please, go right ahead.

Mrs. KELLY. But——

Chairman LEACH. Please, do that, do that.

Mrs. KELLY. If I can get fast answers, I would appreciate it.

Mr. Reider, I just want to tell you I am very disappointed in your testimony. I have had my staff reach out to you on the NARAB provision and ask you for any suggestions you might have to make NARAB better, and we have not heard from you, and I don't think that is helpful. In your testimony, you completely neglect to mention that it would be the NAIC that would control NARAB even if it came into existence. That only if it comes into existence—if your

group, the NAIC, determines in three years that 26 States have not adopted non-discriminatory licensing practices, so I would like you to tell me how many years the NAIC has been working to streamline the multi-State licensing issue?

Mr. REIDER. I would say that we do have a concern with that, we are committed, and we are working very diligently to achieve what you are attempting to do with NARAB, and I think that I can say with confidence that we will be there.

Mrs. KELLY. Your office has not been working with us, sir. Can you give me an answer, yes or no, to a couple of other questions? Have you gotten any States to drop their counter signature laws? Just give me a yes or a no.

Mr. REIDER. Yes.

Mrs. KELLY. I am going to follow up with that, because I would like a written answer to that one.

Mr. REIDER. Sure.

Mrs. KELLY. Do you agree that it is a very real problem with the multi-State licensing of insurance agents?

Mr. REIDER. I think that we are making substantial progress in commonality, and——

Mrs. KELLY. Just give me a yes or a no. Do you agree with the intent of NARAB on that point?

Mr. REIDER. We agree that things have to be done more efficiently and with more commonality.

Mrs. KELLY. That is a yes, is that correct?

Mr. REIDER. That is my answer.

Mrs. KELLY. Is it possible for an insurance agent registered in all 50 States for the sale of two lines of insurance today to be in compliance with all of the standards that he or she must meet without hiring staff just to work exclusively on that year-round? Yes or no?

Mr. REIDER. I am not clear on the question. I would be glad to respond to that if you could——

Mrs. KELLY. OK, an insurance agent that is registered in all 50 States just for the sale for a couple of lines of insurance has to be in compliance with all of the standards—they have to meet all of that. It requires, from what I understand, a great deal of staff time to meet the responses that all 50 States ask for. I am asking you if you know whether or not people can do that without having to hire extra staff? Just give me a yes or a no.

Mr. REIDER. I would answer by simply saying that, again, we are working very hard to arrive at the point where there is commonality.

Chairman LEACH. If the gentlelady would yield.

Mrs. KELLY. Yes, I am sorry.

Chairman LEACH. I apologize. We have about three minutes.

Mrs. KELLY. I know, we have got to go.

Chairman LEACH. So, does she want to come back, because I will give her as much time as she——

Mrs. KELLY. If we can come back—I am sorry, I would like to ask my questions, because then I can ask them a little more coherently.

Chairman LEACH. Sure. Then, let me just say that we will recess until two o'clock

[Recess.]

Chairman LEACH. The hearing will reconvene. When we left off, Mrs. Kelly had the floor. Please proceed as you see fit.

Mrs. KELLY. Thank you, Mr. Chairman. I want to go back—I was talking with Mr. Reider, and, Mr. Reider, we were talking about whether or not you had gotten the States to drop their counter signature law, and you said, what? Yes or no?

Mr. REIDER. My understanding was that we have.

Mrs. KELLY. You have.

Mr. REIDER. There are States that have the counter signature, but there are some that have dropped.

Mrs. KELLY. As a result of your efforts?

Mr. REIDER. As a result of attempting to move forward with what we just spoke about.

Mrs. KELLY. Will you please give me those names?

Mr. REIDER. I will certainly provide those. I will have our staff do that this afternoon or tomorrow morning.

Mrs. Kelly, may I just make a comment, if I may? You had indicated that we have not been cooperative and I want to share something: I am not here as an obstructionist; I am here to work and try to bring resolution, because we believe it is important to move this, but I would say that we are fully prepared, and, in fact, I had extended personally an invitation to you to attend the commissioner's meeting which we held last week. We spent Saturday and Sunday here in Washington for a full day and talked about these issues, and we are coming back in March for our meeting here, our quarterly meeting, and I would extend to you—and I will do it by letter—an invitation to come and visit with us and talk with us.

Mrs. KELLY. Mr. Reider, I represent a district in New York. I don't spend my weekends in Washington, but I will be glad to try to make that possible in March. I just definitely did not get that invitation in time to cancel——

Mr. REIDER. My point is that we are trying to reach out, and I know it is difficult at times for all of us, but I want to assure you and everyone that we stand ready, and I personally would be available to work at any point to be sure that at least there is communication.

Mrs. KELLY. Good. I would hope that that would be the case.

My district, as you perhaps know, borders the State of Connecticut, and you are the Commissioner of Insurance for Connecticut, is that correct?

Mr. REIDER. That is correct.

Mrs. KELLY. I do know that one of my insurance agents that I represent was required by the State of Connecticut to change the name of his agency to include the words "of New York." He had to change his agency name when he applied to sell policies in Connecticut. It is that kind of picky thing where I think that NARAB can be very, very helpful to agents.

Is it true that you do require that sort of thing from out-of-State agents?

Mr. REIDER. I don't know the specifics of that, and I am sure there are situations——

Mrs. KELLY. Well, it is not a specific question. My question is, it is not about this particular agent, but is it true that your State requires people to change names, because I know other States do?

Mr. REIDER. I am not aware of that, but I would share with you that if there are issues like that, and it is not expeditious in getting commerce—we are trying to work to eliminate those types of things. If you are asking me do we have a perfect system, no. But that is why we are working so diligently to avoid those things and to try to get where you want to be and where we want to be.

Mrs. KELLY. I don't see that it serves any possible benefit to require insurance agents from one State to change their agency name if they are going—just to identify something as simple as "of New York" across State lines.

Mr. REIDER. I am not aware of it, but I will certainly review it.

Mrs. KELLY. OK, I understand that some States require fingerprints; others, some counter signatures. Wouldn't it just save a lot all the way along—I have heard stories of places where agents have to go and take a course in a particular State before they can be licensed in that State. I can understand that to a certain extent, but wouldn't it save a lot of time all the way across the board for everybody if the NAIC ran a program that would license agents in as many States as needed; a standard that is higher for all those States?

Mr. REIDER. That is exactly what we are attempting to do right now and with some success.

Mrs. KELLY. Well, Mr. Reider, I would like to hear some—I was hoping I could get some yes or no answer from you. I hope we can work together. I just want to ask one basic question for all of you again since I am running out of time here. I want to ask if there are any of your groups that would oppose financial modernization legislation because it lacks a mix of commerce and banking—the commercial basket is what I am talking about? I just want an answer, would oppose or not oppose.

Mr. Curry.

Mr. CURRY. We are supportive of H.R. 10 in its present form, but we are not opposed to the mixing of commerce as long as there are potential safeguards in place relative to that mix.

Mrs. KELLY. Mr. Geyer.

Mr. GEYER. I would concur completely with Mr. Curry's comments.

Mrs. KELLY. Mr. Reider.

Mr. REIDER. We would agree with what has been indicated, and we do support the holding company approach which was addressed this morning. One of our major concerns, to be sure, is that whatever is done does not adversely affect solvency or our ability to look after solvency, and again, I would suggest that the appropriate thing to do is to come and visit with you; sit down, and be sure that we are totally responsive to the questions that you have asked.

Mrs. KELLY. Good. I hope we can work together.

Thank you very much, Mr. Chairman, for allowing me to continue with the questioning.

Chairman LEACH. Thank you, Mrs. Kelly.

Mr. Vento.

Mr. VENTO. Was Mr. Watt here before me? I can——

Mr. WATT. Mr. Chairman, I don't have any questions.

Mr. VENTO. OK, well, I will just go ahead then.

Mr. Curry, I believe it was your testimony I read some time ago, this morning, that pointed out that some of the State regulated institutions, financial institutions, banks, are limited to only, in fact, exercise certain powers through an operated subsidiary. Is that correct?

Mr. CURRY. Representative, it does vary among States, but, generally, the States—mine, in particular—does authorize activities to be done through an operating subsidiary.

Mr. VENTO. I think your testimony was that some States only permit it to be done through an operating subsidiary. I guess that is right if it varies by State.

Mr. CURRY. Yes, there is a variation in approach.

Mr. VENTO. I mean there is—how many years has that been the case?

Mr. CURRY. In the case of Massachusetts, it has been the ability to use an operating subsidiary is at least 20 years old.

Mr. VENTO. Has there been any instance where there is a demonstration that there is some sort of subsidy with regards to that?

Mr. CURRY. From a safety and soundness perspective, we have not run into any difficulties with those entities that use an operating subsidiary to engage in activities. We also take some solace in the fact activities in a State insurance subsidiary would be subject to the FDIC's review for any potential impacts to the FDIC insurance fund.

Mr. VENTO. Well, we have been through that. In fact, I think you point out in FDIC—and I think the Chairman will recall that we wrote certain limitations on them—that they would have to match subsidiary activities that take place in a national bank. But the issue here, of course, is one different. Obviously, you are finding out that many of them are travel agencies, it is insurance, it is some municipal bond underwriting—I forget what the fourth one was that I read about. Obviously, it is, admittedly, merchant banking or securitization as we anticipated, and as the Treasury has endorsed that activity are not generally done today in the operating subsidiary, is that correct in Massachusetts?

Mr. CURRY. Not in Massachusetts, but I believe in some other States at least on a grandfathered basis it has occurred.

Mr. VENTO. And does occur today.

Mr. CURRY. Yes.

Mr. VENTO. Well, and, of course, it is interesting, because in this case the Federal Reserve Board actually has a regulatory role in these instances, is that correct?

Mr. CURRY. Yes, depending on the structure.

Mr. VENTO. I noticed, Mr. Geyer, you are the insurance—no, you are the State bank regulator.

Mr. GEYER. State securities.

Mr. VENTO. Yes, State securities, and Mr. Reider is the insurance. In this bill, we have the umbrella regulator, and unlike the banks and the securities, you don't have a national regulator, so under the umbrella regulator when there is a bank affiliate and an insurance affiliate anticipated that the rules as to defining products would actually flow through the Fed with the consultation, I guess, of the State insurance regulator, and one of the—I think, Mr. Pope's testimony yesterday, if I remember right, this was the

question I would have asked Mr. Greenspan this morning—Mr. Pope pointed out in his testimony that there is a little—that he would prefer more guidance with regards to the criteria that the Federal Reserve Board would use in terms of making an assessment as to the nature of those financial instruments. Do you share Mr. Pope's concern with regards to that and the fact that the States would not have the type of guidance in this particular instance in the bill?

I don't know how we can resolve this issue. I think, probably, it is necessary to actually deal with a decisionmaker at the Federal level. We had tried—as you know, when Bill left the committee two years ago, we had a financial counsel that would actually define these products, and so even at that point we were faced with the problem without a single insurance entity.

Mr. Reider.

Mr. REIDER. Yes, and we have the example in Connecticut of Citicorp and Travelers. That matter came to the department, and both companies provided all the information that we needed to make a determination. We consulted with the Federal Reserve; they came and spent a considerable amount of time with our office. We attended their hearings, so there was a great exchange of information back and forth in a very cooperative way, and we were able to bring our expertise to bear to be sure that the consumer was protected. That moved through the State of Connecticut and, I believe, a total of thirteen States in a very expeditious manner, and our responsibility of looking after the consumer at the time of that type of movement I think was fully done.

So, our suggestion is that you have State insurance regulators in place to allow them to do the work from the insurance perspective when the primary concern is insurance, and so I suggest that we could work very well with the Federal people at a time of a change of control or on other matters.

Mr. VENTO. Yes, I guess you are talking about control, and I guess that was the point Mr. Pope testified to. But I think he also—it seems to me, it also implied the definition of instruments was also inherent in that. I was more focused on that, but you are right, control is a factor.

Mr. REIDER. Yes, sir.

Mr. VENTO. Pardon me?

Mr. REIDER. Yes, as I said, in that whole discussion—and I participated last year in the discussion with various parties in an effort to try to be cooperative. Again, we are not trying to be obstructionists, but those matters are very, very critical, and we are simply saying that as State insurance regulators, we have 10,000 people across the country, and it is not contrary things, it is one of working in a cooperative fashion. And I think—as I said in my testimony—that that could be achieved very quickly. It is not that it is going to take forever, and we are prepared to sit down and look at that. But we think we can bring our expertise to bear, do the job that we have to do, and yet not get in the way of the other agencies where they are the primary regulator.

Mr. VENTO. I think the issue here is rather what type of criteria or guidance. I guess you are talking about changing the governance, and I am talking about changing the—providing some cri-

teria, additional verbiage in the bill. Not that we need the bill to grow, but I thought that was probably the better tack as opposed to changing the governing structure which, obviously, is not to your satisfaction.

My time is expired, so I will yield—I hope I didn't repeat a question.

Chairman LEACH. No, no problem at all. Thank you, Bruce.

Mrs. Roukema.

Mr. Hill.

Mr. HILL. I thank you, Mr. Chairman, and I want to welcome all the members of this panel. I wasn't here for the testimony although I did read all your testimony.

Mr. Reider, I want to talk with you some about the insurance issues. I would like to just make a point with you—and I think Mrs. Kelly made the point—and that is that I am a friend of yours here and tried to work to strengthen the provisions of last year's bill and will hopefully on this one. But, frankly, I will suggest that your association has not actively engaged in trying to find constructive solutions to the dilemmas that we are dealing with here.

Mr. REIDER. Well, I would—I am sorry.

Mr. HILL. And you folks really do need to, I think, if we are going to protect State regulations insurance in a meaningful fashion.

Mr. REIDER. Can I just comment on that?

Mr. HILL. Sure.

Mr. REIDER. First of all, I think that it is true that we have to be very active and proactive. We, I think, last year gave evidence of that. I personally participated in any number of meetings and talked with many, many people. My colleague, Mr. Nichols, who is with me, has chaired our committee on financial reforms is here today as well, and I can only tell you that we are prepared to work very, very diligently, and we should, and we want to do it in a cooperative fashion.

Mr. HILL. Well, what we are trying to do here is modernize the business of financial institutions, and there are some arcane provisions of insurance regulation, licensing, those sorts of things, that work against that approach of working toward it, and I think that we do need to work cooperatively.

I want to go into the bill itself. In reading your testimony, I found it very interesting—if you were here earlier, I asked Chairman Greenspan about one of the questions that you raised with regard, in essence, whether or not H.R. 10, at this point, preempts State regulation of insurance and whether that is really going to have a meaningful impact on consumer protection. And in your testimony, I think you had attached a graph which is very, very helpful to me, outlining all the various State regulations, State laws, model acts that various States have that are intended to protect consumers, protect policyholders, deal with claims management, selling of policies, premium collection, a whole host of areas that you believe are non-discriminatory; I believe are non-discriminatory, but by virtue of H.R. 10, probably are preempted. And I would just ask if you would, for the purpose of the committee, provide more specifics with regard to individual laws and individual States and with respect to how that will undermine protections of consum-

ers in those States. If you could do that, it would be helpful for us as we negotiate this bill.

Mr. REIDER. Well, we listed the 50 items here, and, certainly, we are prepared to sit down and talk about that, and we are working very hard now to see what might be best reserved for the State and the national level. I gave you, I think, three or four bullet points that we thought were absolutely essential. They relate mainly to solvency and consumer protections that are now in place. And the concern is that—again, not a criticism, because we have worked well with the Federal Reserve and others—but if that is not protected, there is going to be a vacuum. I can tell you that the thousand people we have turn to the State insurance people up in Connecticut for assistance on consumer-related matters, and that every day we spend tremendous energy in our State on the solvency side, financial review of companies on-site and quarterly in our office——

Mr. HILL. And you do a good job of it.

Mr. REIDER. I do believe that we work very diligently in that regard. So we are simply saying that, certainly, we have to do things more efficiently, and you mentioned licensing, and Mrs. Kelly mentioned it. That is a legitimate concern, and for us to suggest that it doesn't put people through unnecessary hoops wouldn't be being up front, but I can tell you that we are working hard to eliminate that, and we are committed along with you. And I think if you listen to Chairman Greenspan, he is saying that if you start this, it is going to evolve. All we are simply saying is don't put us to the side. Allow us to be there; allow us to be an effective regulator, and then see how this thing moves through.

Mr. HILL. I would agree with that.

I have question specific to Connecticut. Connecticut law prohibits State charter banks from acting as an agent for a number of kinds of insurance including title insurance.

Mr. REIDER. Yes.

Mr. HILL. And your State includes some consumer protection statutes, such as one that applies to producers of title insurance, such as mortgage lenders or real estate brokers or other parties. And I presume that you have that there, and it requires, for example, it is there for the purpose of prohibiting institutions from simply creating sham organizations or sale organizations for the purpose of receiving a fee that really don't provide any service in the transaction, which is one of my concerns about the current provisions of H.R. 10 with regard to title insurance. And I think in your State it requires that institutions that sell title insurance must get 80 percent of their business from the public rather than from their business.

H.R. 10 would cramp that is my understanding. Would you agree with that?

Mr. REIDER. That, again, is a complex arena, but my understanding is that it would.

Mr. HILL. Would you consider those laws discriminatory laws or do you think that those laws are there for the purpose of protecting consumers?

Mr. REIDER. Well, I think that the laws that we have in Connecticut on that matter are designed to protect the consumer. It

looks at the capital requirements to be sure there is money in place, and, again, in that matter or any, it is fluid in that we always have to take a look to be sure that it is relevant, but, certainly, what you just described I would agree with.

Mr. HILL. And we have laws in a variety of different areas dealing with certain similar kinds of circumstances to make sure that people aren't discriminated against when they buy insurance or the treatment of their claims or the availability of insurance to them?

Mr. REIDER. Well, I would just say this: that I have lived, I think, in seven different States with my family over the years. And I do know this as a State insurance commissioner now, there are certain situations in a given State that require certain considerations based on the environment, and I think we do have to be careful that is not preempted. That is not to suggest that we should have obstacles, but it does suggest it should be the ability to address unique situations that may need addressed because of the history of product or whatever else, and do that in a way that is open.

The point that I was just going to make earlier, if I may: I want everyone to understand, this is not that we are the enemy of anyone; that is not the case. I think that, for example, the Travelers and the Citicorp emphasizes and brings home the message that we can work together and accomplish what we want to accomplish and that this bill certainly offers many positive things that will enhance commerce and global competition that was spoken about.

So, I just want to emphasize again what you and Mrs. Kelly have said: as an organization, if we have not been as active as we should—and I think at times we have been more active maybe than has been recognized—but, certainly, at times, like anyone else, everyone comes to the game at a different point, but we are totally committed to sit down, and we are very optimistic that all of these matters can be addressed, and I say that with every bit of sincereness.

Mr. HILL. If you will indulge me, Mr. Chairman, one last point, and that is that you have suggested in your testimony that the negative preemption provision that is in there now be replaced with a positive preemption provision and deference provision. I would appreciate it if you folks would provide me with more details with respect to what you are suggesting.

Mr. REIDER. We will, and I also would comment that we will provide you with State-by-State lists comparing the States, and we will do that promptly early next week.

Mr. HILL. Thank you, Mr. Reider, and thank you, Mr. Chairman, for indulging me.

Chairman LEACH. Thank you, Mr. Hill.

Mr. Watt.

Mr. WATT. No, I pass, Mr. Chairman, thank you.

Chairman LEACH. Well, that being the last question, let me just stress again, we appreciate very much your appearance.

I would also stress this whole effort of H.R. 10 is to have bank modernization under prudential regulation that involves functional regulation. There is not a single regulator at the State or Federal level that is altogether happy with all of the provisions. I just want to stress that. And, so what each of you has indicated is where you

would like to see your particular province strengthened somewhat. At each point, there is a countervailing regulator who wants to see his province strengthened somewhat. So what we have here, for example, in banking is the OCC, the national regulator that may or may not be competitive with some of you, but is feeling that it has lost the most. And, so I just raise this relatively speaking. We are trying to come up with a product in which there is a fair degree of fairness and even-handedness, but no one gets exactly what he wants.

Also, this panel I think has underscored what we have seen at the Federal level that just as there are differences between and within industrial groups, there are differences between regulatory bodies both at the State and Federal level, and I don't think we will ever get perfect consensus, but we are going to do our best.

Mr. REIDER. May I just make one comment.

Chairman LEACH. Go ahead.

Mr. REIDER. I think that over the past year as we have had the opportunity to work with the other Federal agencies—and I can't speak for them, but I think that they would share this thought as well—there has been a greater appreciation of what each of us do in our particular functions and that there are ways we can compliment one another. I think that has been a positive over the past year, certainly in the State of Connecticut with the Federal Reserve Board and the transaction I had mentioned. So, we again appreciate very much being here and assure you again that we want to participate and work with you.

Chairman LEACH. With regard to your association, I want to express the appreciation of the committee on an unrelated matter and that is the hearings on the Nazi assets issue that your association has been very helpful in providing witnesses and demonstrating significant leadership at various points of the road. We appreciate that from your association. It has demonstrated solid competence in that particular area.

In any regard, thank you all very much.

Mr. GEYER. Thank you, Mr. Chairman.

Chairman LEACH. Our final panel consists of Mary Griffin, who is the Insurance Counsel for Consumers Union; Mr. Edmund Mierzwinski, who is Consumer Program Director of the U.S. Public Interest Research Group; Mr. Ralph Nader, who is a consumer advocate; Mr. John Taylor, who is President and CEO of the National Community Reinvestment Coalition; Ms. Debby Goldberg, who is the Reinvestment Specialist for the Center for Community Change.

We will begin with you Mary. Welcome back to the committee. And let me say if you all have larger statements, everything will be presented into the record, without objection. Proceed as you see fit, Ms. Griffin.

STATEMENT OF MARY GRIFFIN, INSURANCE COUNSEL, CONSUMERS UNION

Ms. GRIFFIN. Thank you, Chairman Leach. Consumers Union appreciates the opportunity to appear today to present the consumer perspective on the Financial Services Act of 1999.

Over the past few years, we have supported efforts to modernize the financial services industry so long as such efforts move in the

direction of the consumer, not just the financial services industry. We understand the challenges Congress faces in its endeavor to balance the interests of the industry regulators and consumers. While last year's efforts held potential to bring a more balanced approach to the restructuring of the market, we believe this bill represents a step backward for consumers.

Congress must realize that financial modernization can only succeed if fair treatment of consumers goes hand in hand with the elimination of the walls that separate the industries. Opening up the financial services market has the potential to increase competition and choice for consumers, a laudable and desired goal. Unfortunately, consumers' experience of the changes that have already occurred show the great risk associated with your resolution.

Though banks held one-stop shopping as a sort of financial nirvana, studies and reports show that consumers have been misled and deceived about the products banks sell and found themselves nickel and dimed to death with a host of fees. Financial firms have become masters of a marketing frenzy, invading consumers' mailboxes and telephone lines with abandon and almost no checks on their practices. If modernization is not done right, the problems for consumers will only get worse, and the opportunities for more real competition will be lost.

Unlike other private industries, as Chairman Greenspan has pointed out in the past, the bank system is not a free market system. Depository institutions enjoy support from taxpayers in several forms. As such, they should be available for all consumers. But as banks have become full-service financial centers, they have targeted the more wealthy customers. As the *Wall Street Journal* recently reported: "After years of casting a wide net to lure as many customers as possible, banks and many other industries are becoming increasingly selective limiting their hunt to profitable customers and doing away with loss-leaders. Banks are by far the biggest industry that marshals the state of conscientability. Already half of big banks use profit data to make customer decisions."

Technology has helped banks and others develop a multi-tiered structure where the wealthy get better access to services and better deals, and the middle and lower income customers are struggling to pay for access and basic services. This is starkly exemplified by First Union's red-yellow-green light system that weeds out the less profitable or red-lighted customers while giving better deals and fee waivers to the green-lighted customers. Banks can give good deals to their best customers; we have no problem with that, but why should 70 to 80 percent of the customer base get a raw deal from their federally backed banks?

While my written testimony is more extensive, we want to highlight three ways in which Congress can help all consumers get a fair deal. First, enact enforceable retail sales protection for one-stop shopping. When consumers walk into a bank, they need to know whether they are dealing with a bank as an insured depository institution, as an insurance agent or as a securities broker. Measures are needed to ensure that banks sell products that meet the needs of the particular customer, and don't force products on vulnerable loan applicants.

We appreciate and support the inclusion in the bill of a package of retail sales protections, such as disclosure of whether products are FDIC-insured, modeled after last year's bill, which, Mr. LaFalce, we appreciate all the work that was done by you on that. However, the protections contained in this bill need to be strengthened. For example, the bill fails to include the suitability requirements that were in the bill approved by this committee last Congress.

Second, low-cost deposit accounts. Most people need banks, but many cannot maintain the high minimum deposits required to avoid monthly charges. In addition to those 48 million households with $1,000 or less in their accounts who can be hard hit by fees, there are an estimated 12 million households that currently have no checking accounts at all. Low-cost deposit accounts with reasonable service fees and low or no minimum initial deposit or balance requirements are needed to lessen the financial burden on low- and moderate-income consumers. The Full House voted for a bill that included low-cost accounts last Congress. We urge you to reinstate this essential protection.

Third, update privacy laws. As banks, insurance, and investment firms merge into huge money centers, the risk of confidential customer information being shared or sold without the consumers' knowledge or consent becomes great. The Fair Credit Reporting Act contains the only financial privacy protections for consumers, vis a vis the banks, and these are not enough in this mega-merger market.

For example, not only can Citicorp affiliates share financial information about their over 90 million customers to use for cross-marketing, in many cases without the customers' knowledge and consent, but they also can pool data and create their own databases without complying with the FCRA. That means that maybe the bank turns you down because their insurance affiliate told them you are in poor health, and you will never know. Congress needs to close off the loopholes in the FCRA; give consumers control over whether and what information is shared, and put an affirmative obligation on banks and other financial firms to protect the confidentiality of customers' financial and personal information. Legislation introduced by you, Congressman LaFalce, last session would help achieve some of these goals.

In the area of safety and soundness, as you know, Mr. Chairman, we agree with you wholeheartedly that banks and commercial firms should be kept separate because of the potential to skew the availability of credit and relative concerns from expanding the Government safety net to other industries.

As you continue to tackle financial services legislation this year, we urge you to ensure that as you break down the walls that separate banks from insurance and securities firms, you ensure the market serves the needs of all consumers and does not simply cater to the wealthiest. Thank you very much.

[The prepared statement of Mary Griffin can be found on page 542 in the appendix.]

Chairman LEACH. Thank you very much, Mary.

Ed, please proceed.

STATEMENT OF EDMUND MIERZWINSKI, CONSUMER PROGRAM DIRECTOR, U.S. PUBLIC INTEREST RESEARCH GROUP

Mr. MIERZWINSKI. Thank you, Mr. Chairman, Members of the committee. My name is Ed Mierzwinski, and I am the Consumer Program Director with the State Public Interest Research Groups. We are a non-profit, non-partisan watchdog consumer and environmental watchdog organization, with offices around the country.

We are pleased to be here today to talk about the important issue of financial modernization. I just want to make a couple of points in my oral presentation, and I want to say that I concur with the testimony that my colleagues will be giving on the Community Reinvestment Act, and I also concur with the detailed testimony of Consumers Union on the retail sales provisions that should be embodied in H.R. 10 and that, in fact, in some cases are missing, particularly, the suitability requirements.

I want to focus on three specific issues in my presentation today. First, it is critical that the Congress balance this bill, not only between the regulators and the special interest, but also in the public interest, and that means we have got to restore the low-cost, lifeline banking provision that we deleted from this year's mark even though it passed the House.

Second, we have got to protect privacy. I know, Mr. Chairman, you have been a leader on privacy in this committee, and Mr. LaFalce has been a leader in developing privacy proposals. I am pleased that the big brother privacy proposal of "know your customer" is helping to shine a spotlight on privacy issues, but we believe that big business privacy invasions are more significant in many ways than are the big business privacy invasions of "know your customer." And we would support strongly strong changes to this act.

And, third, I will talk briefly just about the fact that we think that the preemption language in this bill, although it is much longer than last year's bill and much more complex to read, still doesn't make it clear that the States retain the authority to enforce consumer protection laws in other areas that the bill does not address. I will point out that part of my concern is that this is an ongoing problem that we have with the Comptroller of the Currency.

Getting back to low-cost lifeline banking, as Congressman Leach pointed out in his question to Chairman Greenspan, big banks charge bigger fees. That is a finding both of the PIRG report and the Federal Reserve Board reports. It is our view that the 12 million American families who do not have bank accounts as documented by Treasury data do not have bank accounts primarily because they can't afford the high prices that banks charge. And the additional 48 million families, Mr. Chairman, have balances of less than $1,000 at any one time, and those individual families pay the brunt of the increase in bank fees—fees on bounced checks, fees on ATM use, fees for receiving somebody else's bounced check, service fees, this fee, that fee, fees for calling the computer, fees for talking to the human teller, and so forth. In addition, banks use or impose significant difficulties on new customers such as holding their checks for inordinate periods of time, and that is another reason people go to check cashers even though check cashers charge high

fees as well. We think the low-cost basic banking requirement is extremely modest but will, again, help the balance of the bill. If industry wants to take advantage of this bill, they should not take advantage of the average American.

Second, on protecting privacy, how much money do you have in the bank? What kinds of bank accounts do you have? What kinds of securities investments do you have? I would like that information, because I want to call you and offer you other products. Right now, banks are providing that information to their affiliates and much more information to their affiliates. Under a very, very weak opt-out provision that Acting Comptroller Williams criticized very strongly last year in our view all confidential financial information should ideally be subjected to an opt-in if it to be shared among affiliates, and consumers should have full, clear disclosure in something like the Schumer Box that was established by this committee ten years ago for the advertising of credit card solicitations, rather than the misleading and deceptive way that banks are currently providing people with the disclosure about their affiliate-sharing.

The third issue on preemption. Preemption rulings of the Comptroller have had a chilling effect on the States' attempts to protect their consumers better. In your State of Iowa, Mr. Chairman, even though no law in the Federal Government regulates ATM fees and even though the Electronic Funds Transfer Act is explicitly non-preemptive and even though in the Riegle-Neal Act Congress told the OCC to back off on its egregious and overly aggressive preemption determinations, the OCC has filed an amicus brief and supported Bank One's attempt to overturn Iowa's ATM surcharge ban. They filed a motion in Federal court in Connecticut in support of Fleet Banks attempt to overturn their administrative ban, and their actions have had a chilling effect on consideration of lifeline banking and other consumer protection laws around the country, and I would encourage you to rethink the preemption provision to make it clear that the States have the right to protect their consumers better except in the circumstances described in this bill.

My testimony goes into greater detail on these and other issues before the committee. I want to thank you for the opportunity to testify today.

[The prepared statement of Edmund Mierzwinski can be found on page 548 in the appendix.]

Chairman LEACH. Thank you very much, Mr. Mierzwinski.

Mr. Nader.

STATEMENT OF RALPH NADER, CONSUMER ADVOCATE

Mr. NADER. Thank you, Mr. Chairman. Needless to say, we can use the old Reagan phrase, "here we go again." It has been going on year after year. A charitable reading of H.R. 10, Mr. Chairman, would be that it is complicated incitement to consumer riot. There is almost nothing here for consumers, and I want to submit, with your permission, my entire testimony and then highlight a few points.

We have had this discussion before on the need to recognize that consumers when they are held defenseless in a complex piece of legislation that they should be given a chance to protect themselves in the private sector. It is overwhelmingly documentable that the

Federal banking system and Federal bank legislation is a massive guarantor, subsidizer, bail-outer of the banking system. We already have seen the S&L bail-out stretch out over some twenty years and with interest and principal amount to about $0.5 trillion because of the crooks and speculators and, not all, but a good many of the S&Ls.

Now, we need to focus on a very modest provision which Congressman Schumer about ten years ago introduced, in which I had a conversation with you once over the telephone, and that is to require these banks to insert at no cost to themselves a postage paid envelope that opens up with a message that invites bank customers to ban together, State by State, Iowa, Nebraska, New York, Pennsylvania, into non-profit charters, financial consumers associations with full-time staff. It does not cost the taxpayer anything. It does not cost the banks anything. The insurance will be paid for by the money raised under the solicitation, and there is no extra postage, and it will be voluntary for consumers to join or not join.

Our estimate is that after two years there will be at least 5 million consumers—at least 5 million consumers urbanized in State after State to provide a prudent balance to the increasing concentration of conglomerate banks displaying overwaning arrogance and indifference and proceeding with a systematic policy to stratify consumers leading to increasing indifference in proportion to the lack of profitability by each consumer account.

And in my testimony, I cite the King Kong of this process, First Union Bank, which needs to be picketed all over the country. It now charges its customers 50 cents per deposit slip; $2 for every time you call a human being after twice a month, and other outrages, but, perhaps, the most outrageous one is stratifying consumers according to their means, and this is called, by First Union, an "efficiency move." That is, according to the *Wall Street Journal*, it monitors each customer account; color codes the account in the bank's computer system. When a customer calls, the computer designates the profitability by showing a small block of color next to the customer's name—green for highly profitable, yellow for not so profitable, and red for customers who don't do all that much to the bank's bottom line. As might be expected, the bank personnel leap to attention in handling calls from the richer customers, but, as the *Wall Street Journal* noted, the bank employees "rarely budge" for a call from a less profitable customer, one where a red block pops up beside the name.

In my testimony, I show that this kind of insert that would produce these voluntary financial consumer associates, so consumers can develop a community intelligence; they can have consumer advocates accountable to them, funded by them that take on the banks when they abuse their anti-redlining obligations; when they overcharge, as Mr. Mierzwinski pointed out, with the bank charge profit centers; when they engage in other activity that affects the safety and soundness of the system, and when they can be fairly confident that the regulators scattered all over the United States are not going to have an idea, much less the will, to apply law and order to these global financial conglomerates.

In Illinois where this insert was legislated by law around 1980 for the utility industry and utility customers, 200,000 residential

utility customers—telephone, gas, and electric services—had banded together, and this group or this full-time staff has saved at least over $3 billion for consumers as well as including a $1.3 billion refund. Just very briefly—it is really amazing here—legislation for the ages—and we are reduced to soundbites.

Very briefly, the one-stop shopping center invites the scrutiny of this committee. This is a tailor-made setup for coercion, for invasion of privacy, and for anti-competitive cross-marketing schemes. We have an economist who has studied this and would be very happy to consult with your staff.

Second, as far as the safety and soundness and taxpayer rights, we have the usual problem of instead of strengthening and rationalizing the disjointed and overlapping financial regulatory system, the legislation makes the system worse by scattering regulation not only among six Federal agencies, but among agencies in the 50 States and the District of Columbia. Your committee and the Congress has been advised by prominent regulators, banking officials, financial analysts, and your own colleagues, as well as the General Accounting Office, who have pointed out the inefficiencies, conflicting interpretations of regulations, and the lack of accountability created by the current system. I have more detail in my testimony.

Why the special treatment for insurance companies? In many of these holding companies, they are going to be the dominant factor as is true in the recent Travelers Group-Citicorp merger. Should they fall on bad times or fail, these insurance companies have the potential to drag down the entire holding company, including banks guaranteed by taxpayer-backed insurance funds. The Federal safety net, not Federal regulation, will be extended directly and indirectly to these insurance affiliates. Federal safety net means corporate welfare which I understand will be the subject of a forthcoming hearing by House Budget Committee Chair John Kasich either next month or the following month.

I noticed that in Section 186, Mr. Chairman, there was little bit of foresight in the bill, because it requires the FDIC to conduct a study of how these mergers will affect the safety and soundness of the taxpayer-supported deposit insurance systems, and, elsewhere, the GAO is instructed to determine the impact of H.R. 10 on community banks and consumers, but only after legislation is enacted. What is this about the barn door metaphor?

The dangers of the Federal Reserve as lead regulator almost qualifies for the Latin phrase, "res ipsa locular." This is a massively indentured big bank agency. It isn't even financially accountable to the Congress. Time and time again, it has showed the distinct capacity of unwillingness to enforce the consumer protection laws under its aegis. It also faces frequent conflicts between its primary role as a money policy czar and its role as a bank regulator. Hard-nosed regulatory decisions that protect the safety and soundness of banks and the tax-supported deposit insurance funds don't always coincide with the central bank's concept of what promotes its whims on monetary and economic policy at any given moment. Indeed, these conflicts between monetary policy and bank regulatory policy are the reasons that many nations separate the two functions. They include Great Britain, Austria, Belgium, Canada,

Denmark, Finland, Germany, Japan, Mexico, Norway, Sweden, and Switzerland.

An extended role for the Federal Reserve cannot be good news for the consumer and community groups, and I quote Dr. Kenneth Thomas of the Wharton School who has published detailed studies of Federal regulatory agencies who describes the Federal Reserve in this manner: "The problem is that the Fed almost always takes a pro-banking rather than a pro-consumer view on major issues. Perhaps, this shouldn't be surprising considering the large number of banks, bank lawyers, and lobbyists who were former Fed employees or, conversely, the large number of Fed Board members, like Alan Greenspan, who are from Wall Street or financial districts instead of Main Street or low and moderate income neighborhoods." By the way, Mr. Chairman, I can assure you that Dr. Kenneth Thomas of the Wharton School does not read Karl Marx on his lunch break.

As far as commerce and banking, this is one area I congratulate you on for your long but victorious move on the floor of the House last year for winning the battle against mixing banking and commerce. I take it you don't believe that General Electric should buy Citigroup or that Microsoft should buy Chase Manhattan. But the issue will be back before this committee, and the battle will have to be joined again, and we know that Senate Banking Chairman Phil Gramm is planning to introduce a version of H.R. 10 which includes a significant basket of banking and commerce.

The great concern about mixing banking and commerce, obviously, is the potential for banks to make credit decisions on the basis of incestuous corporate relationships rather than on creditworthiness, and in my testimony, I do point out some concern about the grandfathering clauses, especially those extending a day or longer, have a habit of becoming permanent, and they also provide lobbying fodder for competitors who will be knocking on the doors of Congress demanding equal treatment and a level playing field.

Let me just add a couple more words, and then I will be finished, Mr. Chairman. I think in a very fundamental and sober sense the Congress is out of touch with the people here. They are not only out of touch with the millions of people who can't afford bank accounts, they are out of touch with people who haven't been given the information to generalize from their personal experiences of being overcharged and subjected to indifference, not to mention the macro-allocation of financial resources that comes from excessive concentrations of too much power and too few global conglomerate hands.

And I suggest there are two broader frameworks of reference that are needed. You need to have some town meetings back in your districts—Buffalo would be a good one for Congressman LaFalce—and we would help get some people out, real solid people who voted for you year after year, and who work hard and play by the rules and trudge down to their banks and get charged for bank deposit slips and everything but attrition on the rug or breathing.

And, second, I would hope that the frame of reference for the promises inherent among the boosters of this bill will revert back to the promises made before airline deregulation, before tele-

communications deregulation, before the Justice Department's pass on the HMO conglomerate mergers, and before other deregulation bills, because what has happened is there has occurred in the airline industry an even tighter oligopoly. It has gone from a broader oligopoly in the 1970's that was regulated to a tighter, fewer airline oligopoly that is unregulated, and without Southwest Airlines, the deregulation would have been truly a disaster. In telecommunications, nothing was a fire sale, a ghost signal from NASA conglomerate mergers and acquisitions.

And if all these other deregulations didn't empower consumers to ban together more easily so they could defend themselves and negotiate for themselves, watchdog the Government regulators, why should this be any different, Mr. Chairman, especially since the process of global conglomeratization is already well underway. Thank you very much.

[The prepared statement of Ralph Nader can be found on page 558 in the appendix.]

Chairman LEACH. Thank you for those modest words.

[Laughter.]

Mr. Taylor.

STATEMENT OF JOHN E. TAYLOR, PRESIDENT AND CEO, NATIONAL COMMUNITY REINVESTMENT COALITION

Mr. TAYLOR. Mr. Chairman, and thank you, Mr. Nader.

Chairman LEACH. If I could hold you for a second.

Mr. TAYLOR. Yes, sir.

Chairman LEACH. We do have a vote on, so what I would like to do is adjourn pending the vote. Hopefully, we will back about 10 after or so. So, the hearing is in recess pending the vote.

[Recess.]

Chairman LEACH. The hearing will reconvene. We were just about to hear from our distinguished and wonderful friend, John Taylor.

Mr. TAYLOR. Thank you, Chairman Leach.

Chairman LEACH. John, you are going to have a long way to go to match Ralph's assessment.

Mr. TAYLOR. Well, I was commenting about—I am glad there was a break actually. But, it is good to be here, Mr. Chairman, and thank you, Representative LaFalce, and other distinguished Members of the committee for providing me the opportunity to testify today.

As the Chairman said, my name is John Taylor, and I am the President and CEO of the National Community Reinvestment Coalition, NCRC; that is the Nation's CRA trade association comprised of some 680 community organizations.

Respectfully, sir, I believe this committee's efforts to reform the banking laws should begin and end with the query of what best serves the average working-class and/or middle-class American. Changes to the banking laws must pass through a prism that ensures that all hard working Americans benefit, and that their access to credit and capital is enhanced, not reduced.

To alter banking laws simply because the laws are over 40 or 50 or 60 years old is to ignore past congressional wisdom. Congress should alter the banking laws, not because Wall Street or the big banks or securities firms or anyone else like that demands so, but because it believes that such changes will ensure the viability of the industry and increase consumer access to bank services and products.

And this is where H.R. 10, as proposed, has several structural flaws and must be reconsidered. With H.R. 10, you are attempting to fix a banking system that is not broken. Our banking system is the envy of the world. You look at Canada and England and South Africa and Germany and so many other countries, you see five institutions in one country, or ten or fifteen or thirty-five institutions. In America, we have 9,000 financial institutions. This unique banking competition provides Americans with the most accessible and affordable banking services and products in the world.

I have heard some bank reform proponents say that because we have so many banks we can't compete globally, but this is contrary to the fact. The United States banking industry has just experienced the five most profitable years in its history, and our ability to compete globally has never been stronger. H.R. 10 does little to promote the bank system's viability and strength, but rather will jeopardize it.

Our banks are big enough and have been able to out-compete foreign banks, because our regulatory structure has limited undue risk-taking. Banks in countries such as Japan with less regulation have gone belly up, Mr. Chairman. We urge you to incrementally loosen restrictions on cross-industry ownership and regularly evaluate the results. That has been our Nation's banking policy for the last 60 years, and I think it has worked well.

Your own comments, Chairman Leach, in the fall on the hedge funds provide us with a sober caution. We should not allow for aggressive bank entry into new activities until a regulatory apparatus has been developed that can effectively monitor and prevent excessive risk-taking. NCRC does not believe that the Federal bank regulatory agencies can foresee what will happen if we eliminate all restrictions on cross-industry ownership. Please go slow on changing the structure of the most profitable banking system in the world. The savings and loan bailout and the accompanying cost to taxpayers should remind us to move cautiously.

Congress has watched somewhat idly as the bank regulatory agencies have used loopholes that have made a mockery of past congressional decisions which established firewalls that prohibited non-banking interests to enter the banking arena. Rather than being outraged that the congressional law and intent was being circumvented by these agencies and financial institutions, several Members of this esteemed body have been heard to suggest we should change the banking laws, because the industry has already de facto changed them for us.

Is this the message we want to send to our electorate? Laws can be changed by simply ignoring them long enough or finding ways around them? Let us remember that these particular banking laws were designed to protect the safety and soundness of the financial industry and consumers' deposits.

Now, some of you might be thinking I have a romantic notion of the financial industry; that consolidations and mergers are inevitable. Sadly, you might be right, but these structural changes should occur in a regulatory environment that protects communities and consumers. There is troubling evidence that mergers result in job losses, fewer loans, higher fees. Literally, hundreds of thousands of jobs have been lost in the banking industry alone in the last ten years due to mergers. As detailed in our written testimony, the Federal Reserve's own studies conclude that large banks, especially those who are involved in mergers, decreased their small business lending. The Federal Reserve survey of fees has reported year after year that large banks charge higher fees, not smaller ones as has been claimed by other folks. And, today, you heard Chairman Greenspan, himself, express some of his own concerns about what occurs as a result of these mergers.

H.R. 10 financial modernization legislation should form a financial industry that promotes the democratization of credit and capital especially in the era of mega-mergers. Democratization of credit and capital means that credit and capital ought to be made available not only safely and soundly—always safely and soundly, but in a color-, gender-, and class-blind manner as well, and I would argue that the right to pursue happiness for one's self and one's family is a fundamental American right, and central to the pursuit of happiness is one's ability to build their own individual and family wealth and, therein, to be treated fairly by financial institutions.

It is not only the Federal Deposit Insurance that connects lenders to CRA and other fair lending laws, it is a more overarching constitutional reason. It is in our national interest and heritage that every American willing to abide by the laws, work hard, and aspire to a decent quality of life, ought to be able to accomplish that goal unimpeded by artificial or discriminatory practices. We do not guarantee that each of us will be successful in achieving that goal, but we do guarantee that people should be treated fairly and equitably in the pursuit of that goal. In this process, we recognize that access to credit capital is a basic American civil right. Republicans and Democrats, to a man and a woman, ought to embrace the concept that in this country every citizen can rely on our Government leaders to ensure that our financial system and institutions will always treat them in a fair and equitable fashion.

Mr. Chairman, as you know, all people in this country are not treated in an equitable and fair fashion, and there is not equal access to credit, and H.R. 10 fails to expand and ensure that fair and equitable treatment by all lending institutions moves closer to reality. The reality is that lending to working-class and minority borrowers and communities is still not free from discrimination. For example, a recent study published by the National Bureau of Economic Research documents discriminations against African-American small business owners. H.R. 10, unwittingly, I hope, contains provisions that only do not address this disparate treatment, but rather misses several opportunities to correct such un-American activities.

Mr. Chairman, my written testimony supplies you with greater detail on where we see the weaknesses in H.R. 10, but I would like

to end by very quickly highlighting four areas where NCRC's 680 member organizations have identified some of the most glaring shortcomings of the bill. It is in these areas that we believe H.R. 10's most glaring failures—contain most of the glaring failures to protect and expands all Americans' access to credit and capital.

First, CRA obligations must be expanded to all affiliates and subsidiaries of banks. This includes insurance companies, securities firms, mortgage companies, credit unions, and other non-depository institutions. You heard from the Chairman Greenspan this morning the impact that CRA has had. I believe he used words like "profound" and "astonishing" in terms of its impact on getting credit and capital into low-income and minority hands. The problem is that all the institutions I just named, including the tax-free, depository-insured credit union industry have no obligations under CRA, and the record shows that they loan to a higher income as a group of people and to disparately fewer and fewer minorities than financial institutions, banks and thrifts that are covered by CRA. H.R. 10 ought to attempt to fix that and see to it that the new institutions that are created—and we commend you, Mr. Chairman, for suggesting that CRA ought to be applied to WFIs—but there are other institutions there that we think also need to have CRA applied to it.

Second, critical to our whole effort on behalf of the public to try to make sure that lenders address credit needs has been the availability of data. The Homeowners Disclosure Act data drives this movement. Because the public and yourselves, as elected officials, have been able to really look and see what lenders have done and not done in certain areas to certain groups of people, the argument and discussion about whether lending is occurring in a fair and equitable fashion has moved from a sort of a morphous-grey, anecdotal discussion to one that really looks at hard data, and that has served all of us well. The problem is that data is not available for insurance companies. There is a real veil of secrecy of what is happening in the insurance industry as it relates to people of color and working-class Americans, and, furthermore, that data is not available for small business purposes, and I was very encouraged today when Congresswoman Schakowsky asked Chairman Greenspan about the idea of whether or not it made sense to expand data collection to small businesses. We heard a different answer than was given in the past, which in the past was he wants a colorblind society and doesn't think we should collect that data. I think he has given it a lot of thought, and I think his response saying that we are going to work on that, and we are going to come to a resolution, and we are going to fix that, was a very encouraging sign. And I would encourage this committee to lead the way and help the public and consumers be able to get small business lending data, and to compliment lenders who are doing a good job in loaning to all incomes and all races and to really address those who aren't and to be able to impact that situation.

Let me also say that H.R. 10 contains a provision designed to expand access to the Federal Home Loan Bank advances for community banks for agriculture and small business lending. This is a logical step since the Federal Home Loan Banks are the main source of liquidity for many smaller institutions that serve every aspect of

their community credit needs, not just housing. However, for this provision to be as effective as possible, further change is necessary.

I am informed by the Federal Housing Finance Board that, as written, the provision would discriminate between the borrowers' abilities of QTL and non-QTL Federal Home Loan Bank members by requiring a significantly higher up-front capital investment for non-QTL members wanting access to the advanced window. Since there are many more non-QTL members in the rural areas, this would effectively suppress the benefits to those institutions and communities that this provision targets. I speak on this issue as a long-time advocate of what we have been calling the Affordable Business Program, or ABP, that would attract seed capital from private sources for focused economic development in underserved areas. The successes of the Federal Home Loan Banks community investment programs provides proof of such a programs merits. I would like to work with you to fashion such a program that can assist local economic development without increasing financial burdens on the Federal Home Loan Bank system.

Finally, Mr. Chairman, of major concern to us is the question about whether or not application requirements that include public comment periods and CRA review. H.R. 10 would exempt mergers between banks and non-depository institutions that involve less than $40 billion from application requirements. And I believe, Mr. LaFalce, in legislation that he has been proposing corrects this, and I hope that H.R. 10, if there ever is a final form, will not have this exemption.

Again, Mr. Chairman, you have been very patient. In the interest of fairness, I hope that one day we community representatives can start out in the morning and that the consumer and public perspective—wouldn't it be nice someday if the industry leaders had to wait until the afternoon and after lunch and that the public and the press get to hear the consumer perspective on these issues? But you are a very fair man, and I really appreciate your leadership on this and the opportunity to testify. Thank you.

[The prepared statement of John E. Taylor can be found on page 571 in the appendix.]

Chairman LEACH. Well, thank you, John. I put you on today instead of the end of the week for that reason.

Mr. TAYLOR. We are getting closer.

[Laughter.]

Chairman LEACH. Well, you are coming before the Secretary of the Treasury.

[Laughter.]

Mr. TAYLOR. That is something.

Chairman LEACH. Ms. Goldberg.

STATEMENT OF DEBORAH GOLDBERG, NEIGHBORHOOD REINVESTMENT SPECIALIST, CENTER FOR COMMUNITY CHANGE

Ms. GOLDBERG. Good afternoon, Mr. Chairman, Members of the committee. My name is Debby Goldberg, and I am with the Center for Community Change. I appreciate the opportunity to present the Center's views on the Financial Services Act of 1999, or H.R. 10.

I know it has been a long day, so I am going to endeavor to stay within my time. I will see if I can do that.

Mr. Chairman, we are very glad that you are holding these hearings on H.R. 10. It is very important that there be the opportunity for a broad range of views to be heard on legislation that will have as profound an impact as this bill will on the way that financial business is conducted in this country.

Some, many of whom you have heard from already, argue that H.R. 10 is badly needed to set the ground rules for the industry restructuring that is already underway. Assuming that this is true, we believe that Congress must act at the same time to modernize the laws that protect the consumers and communities most vulnerable to the disinvestment forces this bill threatens to unleash. So far, this hasn't happened.

We believe that H.R. 10, as it stands now, is fundamentally flawed and profoundly anti-consumer and anti-community in its impact. My written testimony goes into more detail, but I would like to highlight a few areas of concern.

In particular, we believe that the bill would diminish the effectiveness of the Community Investment Act, or CRA, a law that has long since proven its worth, apparently, even to Chairman Greenspan. It will do this in several ways. First, the financial conglomerates envisioned by H.R. 10 may shift activities into holding company affiliates where CRA doesn't apply. This would further erode the financial assets under the act's scope accelerating a trend that is already a significant problem. Today, insured depositories control only about a half of the share of assets that they did when CRA was passed. And this shift has important consequences for CRA and the resources available to support community lending needs.

Second, we feel that H.R. 10 will further fuel this shift through its treatment of national banks' operating subsidiaries. To the extent that it prevents these banks from conducting new activities through ops-subs and instead requires them to be conducted through holding company affiliates, it may have the effect of shrinking the CRA pie.

Although we have concerns about what we understand to be some of the provisions in the bill introduced yesterday by Mr. LaFalce, and, in particular, the mixing of banking and commerce which we oppose, that bill's treatment of ops-subs appears to be preferable from a CRA standpoint.

Third, the new wholesale financial institution, or WFI, created by H.R. 10, also causes us concern. We are glad to see that the bill extends CRA coverage to these institutions, however, wholesale banks simply do not have the same value to low- and moderate-income communities as retail does. For CRA purposes, they are subject to a less stringent standard of performance, and to the extent that they drain deposits from retail institutions, they contribute to H.R. 10's overall dampening on the availability of ordinary banking services in underserved communities.

Another concern we have is the bill's elimination of all meaningful prior approval and public input requirements for cross-industry mergers. We believe such requirements are vital to ensure that the desires of financial industry giants are adequately balanced with

the need to keep credit flowing to consumers and communities who may otherwise be shut out of the financial mainstream.

Last year, this committee considered and rejected a number of amendments that would have helped alleviate these concerns. These include provisions to consider the lending activities of non-banking affiliates in determining the CRA record of holding company banks; to bar a bank holding company from cross-industry affiliations unless all of its affiliates are meeting community credit and consumer needs, and to require the collection of race, national origin, and gender data for insurance policies written by insurance companies affiliated with that holding company. I hope that these or similar amendments will be offered again this year and that they receive more favorable consideration.

Let me conclude by saying that this debate over financial restructuring provides a rare and historic opportunity for a broader discussion about the type of financial systems that American families and communities need and want. I urge you to make sure that the system you design will work for the benefit of us all.

Thank you, Mr. Chairman, that concludes my testimony.

[The prepared statement of Deborah Goldberg can be found on page 601 in the appendix.]

Chairman LEACH. Well, thank you very much. I think it is very important for the committee to hear some critical perspectives.

But let me just go over some things that might be somewhat positive. Let me start with CRA. At the moment, CRA covers about 25 percent of the financial landscape. That landscape is shrinking dramatically. It is the belief of many professionals in the field of finance that unless you have banking modernization you will have the sector of American finance covered by CRA continue to shrink dramatically. And so, a head-in-the-sand approach is an approach which says those institutions covered by CRA will continue to shrink and shrink dramatically.

Second, for those of you—and I think all of you have indicated certain concerns with banking and commerce. H.R. 10 doesn't authorize it, and that is the difference between that and some of the alternatives, but if you do nothing—and I would like to really stress this point—what is happening right now is the biggest breach in commerce and banking imaginable through the unitary loophole, and I think that will just expand dramatically, and so doing nothing is an advancement for those who favor breaching commerce and banking.

Third, there are some small aspects of this that aren't trivial, and we put some sunlight into what is called the Office of Thrift Supervision, which is the least-known Federal regulator, but it happens to have oversight over unitaries which happen to be the breach of commerce and banking. Today, unlike the banking regulator, the OCC, the OTS, doesn't even have to publish its rules and regulations in the sunlight. So, we have applied comparable rules to the OTS, and I would hope that the consumer groups would recognize that as a plus. It is a sunlight circumstance; it is also a comparability circumstance.

Let me mention the Federal Home Loan Banking provisions. Today, the Government-sponsored enterprises do not—I really repeat this as strongly as I can—do not have CRA. What this Federal

Home Loan Bank provision does is pump a greater competitive amount through the banking system and the thrift system which is covered by CRA. And, so it expands CRA through using Federal Home Loan Banks to be tapped by financial institutions covered by CRA. Otherwise, all rural, significant, farm lending in the very near future will be done outside the institutions of finance that are covered by CRA. I personally think the WFI principal is one that is a very close call, and for the life of me I am not wedded to it or violently against it. I believe that if we have it, it ought to be covered by CRA. I would have thought I would get from Ms. Goldberg an appreciation that in the House of Representatives, a newly created institution will be covered by CRA. Instead, I have gotten a critique on that very issue which catches me off-guard, but I will tell you, Ms. Goldberg, as far as I am concerned, WFIs are a very, very incidental financial institution and have some disadvantages, as well as advantages, in the landscape, and I am not the least bit wedded to them.

Ms. GOLDBERG. Can I respond to that?

Chairman LEACH. Sure.

Ms. GOLDBERG. We do acknowledge that you have taken the step of including CRA coverage for WFIs, and we appreciate that, and I know that you worked on that last year without support from some of the other parties that are interested in the bill, but our point is simply that the impact that WFIs have overall in moving resources out of institutions to work at the neighborhood level to make credit and banking services available has, aside from the CRA coverage issue, a negative impact, and that——

Chairman LEACH. Well, but they are designed to——

Ms. GOLDBERG. ——If you are not wed to them, we would be happy to have them out of the bill.

Chairman LEACH. Well, but most people assume that WFIs will be established by securities firms that don't have CRA coverage at all at the moment. This will be the first movement of CRA coverage to the American securities industry. Now, maybe it shouldn't have happened. This committee, by the way, last year, passed out CRA on credit unions, and that was rejected by the Senate. I don't give you any great optimism that the Senate will hold a different position in this Congress. But I will tell you the bill that Congressman LaFalce and Congressman Vento and I helped craft had CRA on credit unions when it left the House of Representatives.

Anyway, I recognize some of the things you are saying, but I would only stress what the non-legislation alternative is that, all of you are noting, that there is a certain combination occurring in finance that has gone on in a very rapid rate. And part of the reason to want to move legislatively is to put appropriate regulatory restraints and safety net circumstances on the new world of finance. It is happening anyway, and if we fail to do that, the Congress will be a bit derelict, and so we are trying to come up with the right construct.

And, now, here, obviously, there is a difference in judgment on several issues, and I think there is a little difference in the panel. For example, I think I catch that Ms. Griffin is doubtful of empowering dramatically the operating affiliate subsidiary; Ms. Goldberg would rather empower the operating subsidiary, is that correct?

Ms. GOLDBERG. My preference would be that all affiliates be covered by CRA-type legislation. In the absence of that, then we see some advantages to the ops-subs approach.

Chairman LEACH. All I can say is all the critiques that each of you, the critique of doing nothing is a pretty devastating one too, and that is one of the dilemmas that we all have.

Mr. LaFalce.

Mr. LAFALCE. Thank you very much, Mr. Chairman. I want to thank the panel for their valuable contributions, and I do want to say that I think you are the most important panel that we have or will hear, because you have one mission and that is consumer protection and promotion, and that is what the primary motivation of all our legislation should be. Albeit, reasonable people can differ as to how we achieve that end.

Mr. Taylor, first of all, congratulations on your article in this morning's paper.

Mr. TAYLOR. What article is that, sir?

[Laughter.]

I am just kidding.

Mr. LAFALCE. I am very gullible.

Mr. TAYLOR. I bring you greetings from one of my board members, Lee Beaulac, who is from your district.

Mr. LAFALCE. Rural development, I believe we have mentioned in the—the organization is; yes, terrific, terrific, organization.

I think what you meant was that you weren't so much interested whether you appeared on a Wednesday, Thursday or Friday, but you would prefer sometime if they could have the consumer panel be the 10 o'clock, the first panel, as opposed to the afternoon third panel when we have more people in attendance, and I hope that that can be arranged the next time we have an opportunity to have a range of panels testify on issues such as this. I concur with you.

You mentioned rural development opportunities, and as long as you have mentioned one organization in my district, Mr. Nader suggested my meeting with others, and, of course, Mary Griffin is from my district and, Mr. Mierzwinski, you are a former Member of Congress, right, so you understand——

Mr. MIERZWINSKI. That is the wrong Mierzwinski.

[Laughter.]

We have the office in Buffalo——

Mr. LAFALCE. I know, I remember. Can somebody provide me with a list of all of the West New York organizations that would be, in your judgment, interested in these issues, please. Please provide me with a list, and I will follow up. Good.

Let me start with you, if I may. In your testimony, you talked about the dangers of the Federal Reserve as lead regulator, and you mentioned that we are trying to repeal Depression-era legislations. We ought to look at pre-Depression-era legislations too. One thing you mentioned just intrigued me, and I am going to ask you to expand upon it. You say "The conflicts between monetary policy and bank regulatory policy is the reason that many nations separate the two functions. These include Great Britain, Austria, Belgium, Canada, Denmark, Finland, Germany, Japan, Mexico, Nor-

way, Sweden, and Switzerland." Would you care to expand upon that, because I think that that is—and I know the concerns you have of Long Term Management. I want to follow your comments on this question, the separation of the monetary policy and bank regulatory policy functions with another question on Continental Illinois too, but, first, would you expand upon your prepared testimony in that respect?

Mr. NADER. Well, the Continental Illinois example is very instructive in the sense that——

Mr. LAFALCE. I think Chairman Greenspan may have misconstrued it a little bit or misrepresented it a bit this morning. I don't know if you are aware of it, but——

Mr. NADER. I didn't hear his testimony, but——

Mr. LAFALCE. Well, he characterized it as a situation, that Continental Illinois exceeded its lending limits on credit to its main government bond subsidiary and dealer first options. I believe that the Comptroller had told Continental to halt lending the first options; had issued a cease-and-desist order to that effect and that it was the Fed who told the holding company, which controlled Continental National Bank, to lend further money to first options. So, the loan was from the holding company owner of the bank, not the bank itself. That is my recollection.

Mr. NADER. Well, that is right. I mean, the primary regulatory agencies for Continental OCC cited a violation and ordered the bank to cease-and-desist in further loans to the subsidiary, but the Fed moved in, worried about monetary policy and the stock market—remember, that was the first big bank that was shaky—decided its purposes were best served by propping up the affiliate, so it let the holding company parent, over which it had regulatory jurisdiction, extend more credit to first options and effectively negated what the Comptroller had decided was the proper move to enforce safety and soundness regulations.

Now, this raises two points: one, the need to separate monetary policy from regulatory policy of this kind—you alluded to it—as other countries do, and the second is to the mish-mash of overlapping regulatory agencies, and my reply to Chairman Leach that if we do nothing, the trends are in the direction of greater breaching of commerce and banking, and so forth. My reply is that we need a rational regulatory structure that doesn't deregulate inadvertently by letting State insurance departments handle the insurance conglomerates here given their track record of poor regulation, and there are all kinds of studies from your own institutions—GAO and, otherwise, experts who you have had saying that you cannot operate a so-called modernization statute with this kind of diffusion at the Federal and State level of regulatory authorities having conflicting interests.

So, it comes back to the answer, yes, we if do nothing, the trends of the big guys will continue, but what we should do is highlight the regulatory consolidation in strengthening part of the bill rather than the way it always appears to the public, that it is a modernization bill.

Mr. LAFALCE. Let me ask you to go into the question of CRA. Chairman Leach has expressed concern about the diminishing coverage of CRA under existing law. It is my concern that if this bill

is passed and we mandate affiliate structures that are not covered by CRA by law, that that will exacerbate, worsen greatly, the tendency, whereas, if we are going to permit these affiliations, but at least permit an operator subsidiary coverage mode of operating covered by CRA, that we could expand CRA's coverage. Would you care to comment on that issue?

Mr. NADER. I might just say, it is not so much a matter of structure as it is of regulatory confidence.

Mr. LAFALCE. OK.

Mr. NADER. And that is not a point that is often made.

Mr. LAFALCE. Let me go back to—Mr. Leach in his version of H.R. 10 has a WFI provision. To his credit, he would extend CRA—some would have a WFI and not have any CRA; some would just have CRA to those portions that carry deposit insurance—but I am wondering if the rationale that permits extension of CRA to an institution primarily as a political tradeoff, because no deposit insurance is in existence, couldn't apply just as readily to an affiliate of a bank holding company.

What do you think about that, Ms. Goldberg?

Ms. GOLDBERG. I am not sure I followed the first part of your question about the rationale, say that part again.

Mr. LAFALCE. Well, if there is a rationale that permits CRA coverage to a WFI where there is no deposit insurance involved, wouldn't that same rationale allow coverage to an affiliate of a bank holding company where there is no deposit insurance involved?

Ms. GOLDBERG. I think there are other rationales for extending CRA-type obligations to a whole range of financial institutions that exist out there; deposit insurance is one small piece of the pie. And certainly from the perspective of as we open the floodgates here for major changes in the way financial business gets done in this country, an important rationale for expanding CRA is to make sure that low- and moderate-income people, low- and moderate-income communities, the average consumer, who is generally not I think who these companies are looking to get into their one-stop shop, still have access to basic financial services that we all need to live our lives.

Mr. LAFALCE. I am not suggesting that we could ever achieve that politically within the present congressional context, especially because Senator Gramm has a disposition very different from that of Senator D'Amato, much less Congressman Leach and myself. But I do think that if we have a rationale for one institution, it could be applicable across the board.

Mr. Taylor.

Mr. TAYLOR. Yes, thank you, I think we do have a rationale. It has to do with the comments I made earlier. Access to credit and capital has to be viewed as a basic American civil right, because if you can't access—CRA nor anyone else says that means the banks have to unsafely, unsoundly give grants or do anything like that. It simply says it has to be available, because without it—I mean there are a lot of things you can get along with in this country. If you don't want to buy wood because you don't like the lumber company, whatever, you can build your house out of steel. There are a lot of things you can do—buy other products and what-

ever, but, without capital, you do not succeed in a capitalist society, and it is a fundamental right for all Americans.

It seems to me, Mr. Chairman, in your infinite apparent fairness—Mr. LaFalce said everything you have said previously—that we should all be in agreement that, OK, we are tweaking the banking laws; we are really changing the air; creating some new structures; setting this and that. OK, how do we guarantee that the right of consumers to have access to credit and capital is enhanced by this bill? And Mr. Leach has raised several issues about it, and I think they are accurate concerns about the shrinking CRA industry, but the only other option isn't what has been proposed in H.R. 10, it is some of what is in H.R. 10 or H.R. 656, but is also addressing the fact that there are a lot of industries that do play a role in providing or not providing access to credit and capital, from the insurance industry and credit unions and mutual funds and others.

They wouldn't be necessarily direct retail establishments, but by applying CRA to them, they could put investments into intermediary organizations, like the Enterprise Foundation and LISC, and others, as loans; it doesn't have to be grants, but investments that would spur economic development in rural and urban America.

And all through the spectrum of all the changes you make, if we were in agreement that fair and equal access to credit is something we want to accomplish and we don't to limit that, but rather need to expand it, because of the reasons you have articulated, Mr. Chairman and Mr. LaFalce, because of that, we are going throughout the spectrum of this bill to create provisions—and I think part of the problem is—and you said it in this congressional environment—is the quality of the dialogue is instead of talking about the real impact of CRA is, we had the Chairman of the Federal Reserve sit here himself and use words like "profound" and "astonishing impact" and "it is good law" and "discrimination exists."

Study after study has shown the impact of what CRA has meant and that it is not about bad lending; it is not about forcing the bank to open the vault and throw the money out in the streets. Time and time again, we hear this evidence, and what is the discussion? In this House and in the Senate, it is about whether there are bank extortionists. And I think it is incumbent upon the leadership in this House and in both parties to raise the quality of the dialogue to start talking about why CRA is about something more than just depository insurance, but rather is simply a fundamental American right that all hard-working Americans and, frankly, everyone of your relatives and ancestors benefited from, not from CRA, but from the ability of being able to access credit and capital in one form or another, and if they didn't, many of you wouldn't be here. And it just seems to me that if we can change the quality of the dialogue at least from this committee, from this day, and from this House, we begin to talk in terms of access to credit and capital as something that is just the right thing to do for all Americans, not Democrats or Republicans or poor or white or black, but simply for all Americans, and that we are going to design legislation that modernizes banking so that we ensure that this is expanded and enhanced, not reduced. And, frankly, with all due respect, Mr. Chairman, your legislation just doesn't do that.

And on the ops-sub—I have got to get in very quickly on the ops-sub issue—let me just tell you, there is a big difference between whether we end up with the affiliate structure or the ops-sub structure. The Secretary of the Treasury, the Comptroller of the Currency have put in writing and made it very clear that for purposes of CRA, operating subsidies would be counted as part of the asset base of the institution and their ability to do lending in low-income and moderate neighborhoods. The Federal Reserve has made it very clear that they would not count it; two fundamental differences and the FRB alternative would really hurt low- and moderate-income consumers, those two very different perspectives.

Furthermore, the Federal Reserve—you might not like this one—but the Federal Reserve was designed—and I think rightfully so—to be extremely insulated from public pressure, and, presumably, so that they would not have the sort of public pressure of the day to affect their monetary policy work. But what it also insulates them from is even from Congresspeople being able to impact them for CRA purposes. This is not the case——

Chairman LEACH. You would rather have the Chairman of the Senate Banking Committee influence?

[Laughter.]

Mr. TAYLOR. I would rather have someone be able to stand up and encourage—whether they are a Republican in the White House or Republican appointment in the Treasury by a Republican or a Democrat—I would rather be able to have a conversation and have some ability to be able to influence them to enforce the fair lending laws, because, frankly—and I think Chairman Greenspan is a heck of a guy, and he is charming, and he is hard not to like, and you saw some of the freshman Congresspeople drooling as they sat in front of him—but the reality is this—and he said good things about CRA; I don't begrudge that—but the reality is this is so far down on his radar screen of the important things that he thinks he needs to do, that it really has had a very negative impact.

I can tell you from the 680 organizations that I represent, the experience with the examiners from the Federal Reserve and the lack of the import they place on this is very different than what you get from the OCC. Gene Ludwig and now Jerry Hawke are people who, at least publicly and at least through their examinations, really talk about this stuff being something that is important to them. We still have a lot of criticism; we have a lot of problems, and I think we have a way to go, but there is substantive differences in terms of the two institutional approaches of the enforcement of this particular fair lending law.

Mr. NADER. Let me just make a comment on your critical question of reciprocity. Now, obviously, the first enablement for a reciprocity argument on CRA is FDIC. By the way, you know the FDIC has less in its reserves now than any one of 10 banking failures could draw on, because they are not assessing the banks at a time of record profits; that is when you develop a rainy day fund. But the argument is that the rationale to extend to CRA-like responsibility is FDIC.

Now, look at the reality. The safety net is expanding to any affiliates that can jeopardize the banking system, whether it is insur-

ance or whether it is security firms. There is really unbridled discretion here under Federal law. In fact, I was trying to get some law reviews to write an article on the meta-law system that operates in this area, the really unbridled discretion, the meta-law—in other words, meta; the unbridled discretion that you saw operating in the Mexican bailout, as it is popularly called by Rubin, with the close association of Mr. Greenspan. But in this section, does anybody doubt that if Citigroup gets in trouble because of its insurance affiliate, that the Federal Government will not extend the safety net either by Executive discretion or by legislation?

And, so the rationale that you are inquiring into is not just FDIC, it is a penumbra of realistic and unbridled discretion that the Federal Government will do whatever is necessary to save these conglomerates. And an example—and the not most egregious one is Long Term Capital Management. Have you ever seen a more misnamed group, by the way?

[Laughter.]

Talk about a derivative operation calling itself long term. When I read that, I said, Chairman Leach should really chuckle over that name, since he brought to the public's attention the derivative investing-mania some years ago.

But here is where the Federal Reserve, New York to be sure, mostly, but with Greenspan's knowledge, basically going to banks and saying, "We can't require you to do this, but we think it is pretty important to anti up $1 billion." So, that is one of the reciprocities, the expanded safety net.

The second one goes——

Chairman LEACH. You are off by a quantum measure; it was $3.5 billion.

Mr. NADER. Oh, I am sorry. I would like to be corrected in that way.

Senator Sarbanes, in the hearing last year, when we were fumbling around developing this—trying to articulate this rationale, delivered a three-minute statement on how the very essence of the Federal Banking System, the Government, allows the banks to engage in their multiplier and leverage effects in the capital and financial market, and it is the most fundamental rationale, and that is forever; that doesn't bob up and down with amendments to CRA or FDIC limitations over non-bank affiliates, and I really commend—I was awed by that demonstration by him, even though I think he gives up too early on this bill.

You should go back and see the rationale that he delivered on that, and I think between the safety net expanding without limits and Senator Sarbanes' description of the Federal Government's banking system, there will be no question that CRA-like obligations need to extend to all of these financial institutions.

Ms. GOLDBERG. If I could add one more point in response to your question, Mr. LaFalce. In the absence of the kind of extension that you are talking about, we have what is a rather perverse situation where you can have a bank, an insured depository, covered by CRA, owned by a holding company, that may, in fact, have a decent record operating in particular communities and an affiliate of that same institution that is not covered by CRA that may be competing

for business in the same communities offering loans that are at best high cost, and at worst predatory. But the affiliate can get away with it, because they have no obligations to serve low- and moderate-income people in the same way that CRA requires for its sister institution.

And from the consumers' perspective, it can be very difficult to know which door you are walking into with holding company affiliates. People tend to think if there is a bank-like name on the door—you know, we have talked about this in another context—that you are dealing with the bank and they expect that they are getting what might be a reasonable deal when, in fact, they may be getting a raw deal.

Chairman LEACH. If I could yield to Mr. Vento. Mr. Vento is recognized.

Mr. VENTO. I think we lost a couple of Members here. One was Ms. Schakowsky. She has been advocating, obviously, this business loan data, and so I wanted to point that out to you, and I think it is an important issue. My colleagues and I all would like to be able to do more in this bill. Obviously, it is a question of what you can do. I think the real problem here is that many of the groups that are supportive of it, if you tip it over just a little bit too far, it ends up tipping over the entire boat. It is a concern I reach in terms of consumer issues.

There are, obviously, some differences with the panel in terms of the commerce and banking. I think that we agree, most of us agree, are willing to go along, I think, with the ops-subs. Obviously, we have got a major impediment in terms of the Chairman, and we have got some problems on the commerce and banking issue, though, that there is disagreement on, that comes from a lot of different quarters. Principally, from the historic role of securitization and insurance annuities, most of them have some equity investment issues, and there may be some that flow to banks that—you know, we can look at examples of raising the specter of the S&L crisis or other matters and find that there are commerce banking issues, and sometimes a raise in terms of direct investment in them, that their fundamental problem was their loan portfolios.

So, I think the issue here is that if you have—I mean, I don't know that any of you have any specific examples right now of banking and commerce in this country that have been a problem, because we didn't have that absolute prohibition until when the bank holding company laws were written in the mid-1950's, and so I think that if you have some concerns like that, or if you have some examples, I would like to know about them, because we have had—obviously, this bill goes into expanding banking and commerce in the sense of CEBAs and, obviously, retains that issue with regards to unitaries.

And then you have heard—I don't know if you were here for the whole discussion with regards to State-chartered institutions already have commerce role in many respects, and, of course, our edge corporations in terms of U.S. banks operating a profit that have a commerce role. And no one, I don't think, wants to model themselves after the Japanese or German banking in financial institution systems, but we are talking about something that is pragmatic. I don't think any of us—frankly, there are a number of insti-

tutions that their companies actually own banks that have been grandfathered—about five or six of them—and they haven't had any problems. They don't think 3-M is going to run their loan program through the banks that they own in my area. 3-M is headquartered in Minnesota, and they own a bank, but they have not used it that way, because it simply isn't that efficient. You are better off putting out bonds and securitizing in that manner.

In fact, of course, banks have gone that way—I think the issue here in terms of operating service—and, frankly, I look at the CRA issue as really an extension of trying to deal with a revisiting of the whole franchise purpose by which we extend banks. I mean, the money multiplier that Paul Sarbanes talked about and the role of banks in terms of grading credit within our communities is a vital—it is a Jeffersonian concept, and trying to keep these institutions current in terms of powers today is essential if we are going to meet the economic growth needs and the needs of these communities.

I think the real strength of the CRA is, of course, that it has a creditworthy basis and workable, and I think if it led financial institutions, in a sense, back to where their roots are and doing the job that needs to be done in terms of extending credit—I mean, this is really part of the strength of our entire economy, and so we want to get this bill right, but one of the functions is to make certain that those financial institutions that are based on models of yesterday are able to do it.

What is happening today is a lot of money is flowing out into mutual funds, and that is really where the competition is going. I mean, it is flowing out of the institutions which could or should be diverting and operating creditworthy services, and so that is the concern, and if we put those back into those small banks—that is why the ops-sub, I think, becomes important in some of these other structures is because we want to be able to continue to serve the credit needs of our community.

I mean, I have had official studies done in my district in Minnesota of lower, socioeconomic income neighborhoods and so forth, and they find that in terms of total dollar amount, that they are actually—the financial institutions in those areas are taking money out of those low-income areas—the Social Security savings, the other savings—and spending it in other places, because they haven't had the ability to, in fact, to reloan the money back into those areas, and that is what is really going on today is even in these low-income neighborhoods—and really when we ought to be investing and putting more money into this infrastructure in these communities, we are actually taking money out of them.

But I think the banks are doing really a pretty good job with CRA today. I mean, I am pretty proud of the small banks in St. Paul and Minneapolis, as a matter of fact, for the job that they are trying to do in most instances, not in all instances.

A question that hasn't been brought up—and I think we all probably agree on this, more or less—obviously, there is some with commerce banking, but if you have specific examples of that you want to send along where is the problem, I would like to know about it. I think it is pretty clear here we are going to have some commerce and banking mix, but it is a question of how affirmative this bill

is, if we are going to do it on the basis of the language of the Chairman's financial nature and then apparently complimentary, but we are going to actually deal in percentage terms. So, I think it is going to happen. In this bill there is a reverse of 15 percent for 15 years, as has been pointed out in some of your testimony, where there is commerce and banking that is going to occur with insurance and with securities, and that is going to become a distinction without a difference down the road, because these are going to be—I mean, it is going to—I wish I could stop some of these mergers too, but under the existing antitrust and other laws that we have, we can't do it. I just had—you know, was one of the few voices complaining about Norwest, and there weren't too many. We had hearings on it, but that didn't do any good; they trotted out some of our good friends that are getting help from the community to tell the virtues of Norwest Bank.

[Laughter.]

Mr. TAYLOR. Well, that is part of what Senator Gramm is trying to get our representatives——

Mr. VENTO. Well, no, these guys are coming out and testifying on the other side about being in favor of the mergers.

Mr. TAYLOR. He pointed that out as well, but he is opposed to banks paying groups to come up and say wonderful things about them.

Mr. VENTO. Well, he didn't have to pay them.

Mr. TAYLOR. He is being balanced on that end.

Mr. VENTO. These guys came on their own; they didn't need any pay; they didn't need much prompting. They were delighted to support Norwest Bank because of the good things that they had done in the community, and it was enough to—and, so I think they outnumbered, in fact, in terms of those that were raising questions. But this one question is, you lamented to the fact there is not a lifeline account in this bill, but I think that most of us talking about the lifeline account in the last go-round with regards to this two years ago, we are really talking about the ETA accounts required by the law, and so they have actually, in fact—Treasury, now, has come out with an account. I know that there is some concern about it, but I think that I was wondering your reaction to that and if we should try and track that in this particular—I mean, I understand what you want to do. It is really a flash point, incidentally, in the bill with regards to financial institutions. They were never convinced of the benign nature of the amendment as I was with regards to actually simply tracking the loss with regards to the mandatory deposit accounts.

Mary, do you want it or Ed?

Mr. MIERZWINSKI. Well, Mr. Vento, first of all, I want to say that Mr. Taylor's distinguished commentary on the access of credit and capital and Mr. Nader's extensive remarks on the extension of the safety net, whether it is de facto; whether it is by Executive fiat, whatever the imperative is that causes the Government to back the safety net of these institutions whether or not they are insured or uninsured, this industry has tremendous benefits that flow to it from the Government, and all we are asking is that it does not leave average, working-class Americans behind.

The ETA account that the Treasury has proposed is designed to establish kind of a second-class banking system for people to get transfer of benefits. We are asking that banks—federally insured, and so forth, and so forth—provide accounts that are reasonably priced and are affordable, not only by people collecting benefits, but by working Americans, and 48 million—to reiterate a point that both Ms. Griffin and I made and is from Treasury data—48 million Americans have less than $1,000, on average, on balance in their bank accounts. An additional 12 million don't even have bank accounts, and I just find it incomprehensible that the committee just doesn't stand up to the American Bankers Association and Mr. Brackley's association and say it is a condition of financial modernization that we bring along everybody and require you to provide low-cost, lifeline banking accounts, and that is really our point.

Ms. GRIFFIN. I wanted to respond both to your point about low-cost accounts and because we do think that it is a broader issue than just the ETA accounts, although we understand that there is movement for the ETA accounts to remain more affordable.

But Mr. Leach has pointed out, which we appreciate, about the major compromise in trying to get something done when the market is going to do it anyway, and we agree that there should be something done. I guess from our perspective there are a number of issues of safety and soundness which are critical to consumers, and we completely agree with you on that, and we worked very hard on banking and commerce. We even agree with you about the affiliate approach, which is not what everybody agrees with.

But I think the other half of that, which we feel as impassioned as you do about banking and commerce, is that the market—and we have seen this in telecom, and we are seeing it in other deregulated industries—is moving more and more to the top 20 percent. As that *Wall Street Journal* article mentioned, big banks are calling "bad" customers those with $1,000 and under in their accounts and, as Ed just pointed out, that is 48 million American households. So, 48 million American households are being red-lighted, and we think that at some point there is a role for Congress, when you are dealing with federally backed institutions, to step in and say it has to got to work for everybody.

When you go home and you talk to people, they talk about fees, and they talk about their concerns about privacy. We have huge, gaping holes in the Fair Credit Reporting Act that are only going to get worse and worse with these mergers. I, right now, can get information on all of your bank accounts. I can get information on transactions. If you are lucky enough to get an inheritance from a nice aunt or something, I can find out about it. I can find out a lot of information; I am not legally prohibited from finding that out. People don't even know that. When they hear that, they get even more excited about their privacy.

What we are saying is these are some of the things that we don't see how the market can work unless these situations are taken care of and unless it is taken care of for everybody. We are not talking about banks leaving out 10 or 20 percent of the market; we are talking about 80 percent of the market being underserved right now by federally backed institutions. And when we look at "com-

promise," we look at the overall bill, and what are banks giving up? Banks are giving up an unfair competitive advantage. I mean, it is sort of like a 16-year-old who has to give up his Corvette. I mean, I wouldn't call that a compromise, and when you look at insurance and securities, what is happening with them? They are going to be able to get into the banking business.

Now, we are going to be giving up some consumer protection. We are going to be giving up State laws and the ability of State regulators to protect us. So, I guess from our perspective, we see safety and soundness, and we see day-to-day consumer concerns. And we are just trying to get it across that there has to be more of a balance in this bill, and it just isn't there yet, but we appreciate the effort, and we are here to keep working on it.

Mr. VENTO. Well, I don't want to continue this; I think it has been a great discussion. I just think that one place we might look to is where there have been some—there is a reluctant agreement. I mean, the banks still—there are some that don't want, of course, what the end result was with the direct deposit accounts that Treasury has agreed—the Government has agreed to pay for the establishment of some of these accounts, and then the Federal Government saves money by direct deposit, so they are willing to compensate or try to facilitate this process.

There are a significant number of individuals that receive these, and I am not talking about electronic benefits transfer, this is actually electronic transfer accounts with direct deposits. I know that the electronic benefit issue is an important issue, because we were, again, in our State, we were one of the jurisdictions that began that. Now, it has, of course, spread to several others. It has had its problems, I guess, but it, by and large, is a better thing in terms of the administration of these programs. But there are many that will not, in fact, engage, but I think the 48 million that have accounts, that these really represent a business opportunity for financial institutions in my judgment.

Obviously, there are many that want to shift the focus of what their business is, but, nevertheless, they have a franchise in these communities and these areas to serve. And one of the bigger complaints is, of course, converting everyone into an ATM and not being able to get direct fact-to-face type of services.

There are a lot of major problems along those lines, but I have read your testimony, and I don't want to continue, but if you have examples on banking and commerce problems, I would like to know about them; specific examples that relate to that, because since there is a lot of anxiety about it, I can understand. I have anxiety too, but I need to have facts. Thank you, Mr. Chairman.

Chairman LEACH. Thank you, Mr. Vento.

Mr. LaFalce.

Mr. LAFALCE. Thank you, Mr. Chairman.

Mr. Mierzwinski, you argue very strongly on page 8 against the mutual redomestication provisions that are in H.R. 10. I agree with you, but could you explain in more detail why this change in Federal law would be so unfair to mutual insurance company policyholders and where, in particular, the policyholders might be most especially affected? Of course, if anybody else wants to comment on that, you are free to also.

Mr. MIERZWINSKI. I will just let Mary answer this one.

Mr. LAFALCE. Sure, sure.

Ms. GRIFFIN. Currently, without a mutual holding company law, current mutuals would go through a traditional mutualization. In a traditional mutualization, the assets of the company, insurance companies, or the surplus of the company is valued and formulas are determined to determine how much the policyholders will get based on how long they have been with the company and the type of policies that they hold with the company, and then they are given either stock—outright or greater insurance benefits, and/or just straight cash.

Under mutual holding company structures, the first step is that the policyholder's interest in the policy is split from their ownership interest in the company. So, the mutual is converted to a mutual holding company that holds under it an insurance company. The policy goes with—as a policyholder, it goes with the insurance company. The ownership interest goes with the mutual holding company. The mutual holding company is basically just on paper. It doesn't really have any assets, and there is nothing to gain from that. And then what they have been doing is giving the people the right, when they convert to stock, to purchase stock from the company, and that is one key difference. In the traditional mutualization, you get the stock. In other words, you either get a $1,000 worth of stock or you get a call that says, "Do you have $1,000 to buy stock?" Now, clearly, one is better than the other. For a lot of people who have been doing insurance for many years, they call it thievery. I mean, it is just out and out——

Mr. LAFALCE. It is prohibited in certain States, isn't it?

Ms. GRIFFIN. Where mutual holding companies are not allowed, they have to go through traditional mutualization, such as New York.

Mr. LAFALCE. Yes.

Ms. GRIFFIN. And I know a lot of the New York——

Mr. LAFALCE. And a lot of other States, too, right?

Ms. GRIFFIN. Right, a lot of other States. It is the biggest issue in New York, because that is where the biggest mutuals are right now. But, as I am sure you know, a number of those mutuals who were fighting for this last year, are now going for the traditional mutualization process, and they argued that the mutual holding company process was too cumbersome, it was too expensive, but——

Mr. LAFALCE. And the changes proposed to the law would permit them to do it in a different State, is that right?

Ms. GRIFFIN. The changes would permit them to go to another State that has a mutual holding company law and take advantage of that law, so they would not—they could avoid doing it under traditional mutualization, and it is particularly important in New York I believe, as New York probably has some of the strictest redomestication or movement laws on insurance.

Mr. LAFALCE. I really consider that to be one of the biggest anticonsumer provisions being proposed. I would like to see that limited.

Let me go to a separate issue now.

Mr. NADER. By the way, the New York State Assembly report is very key on that point as well.

Mr. LAFALCE. Very good on that point, yes.

Mr. NADER. That is available for the distinguished media in absentia.

[Laughter.]

Mr. LAFALCE. Can we talk about something else that I think is pretty important too? And that is our consumer protection that I have tried to provide in my bill and that is suitability standards. Ms. Griffin, can you tell me why you think that suitability standards are important and the type of abuses that you have seen without suitability standards?

Ms. GRIFFIN. Well, suitability standards simply mean that the product that is being recommended by the particular person at the bank would meet the particular customer's financial needs based on the information that the customer provides. In other words, if the customer won't provide information, you can't hold someone to a standard without having that information.

It is important, because what has happened is people come in—there was one case that I believe the banking commissioner, maybe, or securities commissioner of Ohio brought up today. We had heard of a similar one, of a 92-year-old woman in a nursing home that had a bank branch downstairs. I have spoken with the woman—she went in with $10,000 or $15,000; they sold her a product—and she said, "I need a certain amount of income to live every month. All I want is safe and secure. I want the income to live." Now, apparently, the seller at the bank was betting on time or something, but he put her into a stock bond and, basically, her money was just being taken out to pay her that monthly amount. They were just paying her the principal. So, she had a broker; she did not want to use the bank as a broker. Two or three months later, she was talking to her broker about something, and her broker was looking at her accounts, and her broker said, "What are you doing? What is this bank account here?" The broker said, "Did you realize that you bought this stock?" Actually, it was not a stock fund, but stocks, and the woman said, "I had no idea," and they immediately canceled that transaction, but in the meantime she lost $4,000 to $6,000 worth of principal. That is clearly an unsuitable sale for a 92-year-old woman, and we would like to make sure that the suitability requirements are put on any seller of those products who sell them from the bank.

And I would like to point out something that a lot of times the insurance industry argues, and the banks argue, "Why should we do suitability for insurance?" In the NARAB proposal, one of the requirements in the National Association of Registered Agents and Brokers is that all insurance agents comply with suitability requirements. So, we don't see why it is so difficult to put suitability requirements in the bank sales when the agents themselves are apparently ready to go along with it, which is a newer concept of insurance.

Mr. LAFALCE. I agree with you.

Mr. Taylor, a number of people agree that there should be adequate compliance with CRA as a precondition to affiliation, but I

also think that you need some continuation, some modeling, so that if you fall below certain standards, you could have some enforcement mechanism, and I think that is extremely important. We can sustain the CRA commitment. What are your thoughts about the necessity for some enforcement mechanism to ensure continued CRA compliance?

Mr. TAYLOR. Well, there is no question that——

Mr. LAFALCE. And what would you see as a possible or probable result if you didn't have an enforcement mechanism?

Mr. TAYLOR. Well, we didn't have it for the longest time. We had the law, but there was no enforcement, and I think when many of the staff and the regulatory agencies are being open and honest and will admit that for a great period of the time, this particular law, this CRA, was a "stepchild law" and something that just wasn't very high on their radar screen. And, frankly, thanks to this body, I think it has moved up in its importance, and we have gotten more enforcement, although I think what Mr. Nader referred to as the incestuous relationship between the regulatory agency and the industry is very problematic.

We really do need to have an enforcement agency that sees it as their job and sees consumers as their clients and not just banks as their clients. That having been said, I think the impact of enforcement and not just from the regulatory agencies, but from the Justice Department, and we give thanks to the Bush Administration for bringing the very first fair lending case in this country against Decatur Federal & Savings and then Ms. Reno bringing eleven cases since she has been in office. That has helped lenders not make bad loans or unsafe loans sound loans, but rather pay attention to this law that they for many years and, frankly—I don't want to sound like an apologist for the bank, but if the regulators didn't care about it for the longest time, why should they? That is changing, and enforcement is key.

The problem, now, is from the lending industry we hear that there is no value in an outstanding rating, and why should they struggle to get an outstanding rating and do a great job—we hear that repeatedly—and from community groups we hear that enforcement is so easy now—it is a wink and a nod—and, indeed, we have gone from just five years ago 11 percent of the industry getting failed CRA ratings to less than 2 percent, and that has an impact.

We are looking at the numbers now of lending in low-income communities to minorities. In the last year, year-and-a-half, are not heading in the right direction. We saw a great period of time where there was a lot more lending, and I think everybody was pleased with that. Again, we haven't seen any default or any bad loan problems come out of that, but rather still safe and sound lending, but we are beginning to see with more lax enforcement we are heading in the wrong direction. And, obviously, that is why H.R. 10 and whatever you do with modernization, if it doesn't reinforce and expand the importance of these kind of laws and regulations as it relates to access to credit and capital, it is going to exacerbate the problem and only hurt people's ability to get access to credit and capital.

Mr. NADER. And enforcement without a facility for people to band together back home, become informed of their own cham-

pions. Without that facility, enforcement is going to be very dubious, and the law will serve to legitimize private corporate power instead of to advance public and consumer justice. So, I always come back to that facility in the bank statement or any other conveyance so people at their option can ban together and fund their own financial consumer association.

The trouble with this bill also is that the corporate structure is so fluid, is so transnational, is so complex, has so many different ways of transferring assets and moving money around instantly, that it takes more than a genius of the legislatures to be able to shape legislations anticipated without the organized citizenry behind it. It is not like the public utility holding company in 1930 which was a genius of a drafting success. What they had to deal with with these pyramid utility holding companies is child's play, both jurisdictionally in a global sense and in terms of the tailored complexity and maneuvers that these structures can attain, and you desperately need the organized people back in your home State to make any law enforceable, but, more important, to make a law good in the first place, so it is worthy of being enforced.

Mr. TAYLOR. And If I might add, Mr. LaFalce, and I think that process is undermined by something that I would like to bring to the attention of this committee, and that is the process of the public hearings that the Federal Reserve has. Representative Vento might have thought I was kidding, but I wasn't kidding when I was saying that I think banks pay in both directions. Banks fund community groups, and what happened in some of the hearings—I won't go into names, but I can document and give you the information if you are interested—but banks take away airline tickets, hotel tickets, the whole shebang, to get groups from different areas to come to the hearings and testify on their behalf, and you get these groups that would come up and literally say, "This bank gave us $750 to a Just Say No campaign at our high school, and it is a wonderful bank." And what the Federal Reserve does in the process of these hearings—I know, because we have experienced this, many of our members—is that they ask you, "Are you testifying 'for' or 'against'?" And you tell them, and then when the "against" list gets full, they take no more hints, and they wait until the "for" list gets full, if it does get full.

And so what they do is artificially imbalance public comment on this, and what they need to do is they really need to look at people who are looking at community investment activities and the fair lending activities of the bank and not just somebody who is there and they are happy because they have got a $10,000 grant to build a shelter or whatever. Not that that is a bad thing, and we ought to encourage that, but this really is about fair and equal access to credit for individuals and communities and how the bank doesn't hold neighborhoods through whole populations, not whether a group gets a grant.

Mr. LAFALCE. This reminds me of an article that was written in the *Wall Street Journal* in the late 1970's or early 1980's by Herb Stein. And he said that the *Wall Street Journal* takes the six economists that favor the gold standard and the 15,000 that oppose the gold standard, and they have six articles for the gold standard and six articles against the gold standard, and the world thinks

that there is an even-flip division of authority amongst the economists.

Mr. TAYLOR. And all the editorial——

Mr. LAFALCE. I always remembered about that piece by Mr. Herb Stein. They called it a crazy idea.

Ms. GOLDBERG. Mr. LaFalce, if I could make, I think, another point about the issue you are raising on this, the CRA standard for cross-industry affiliation and the lack of any sanction for banks that should fall out of that standard post-affiliation. It is not that hard, particularly, for the banks that are likely to engage in these cross-industry mergers to get and maintain a satisfactory CRA rating. So, it is not like we are putting a goal post that is all that high out there for them to get over. If they can't keep at least that level of performance—as John pointed out, 97 to 98 percent of the banks are at satisfactory and above—if they can't maintain at least that level of performance, then there ought to be some sanction available to the Federal regulators if they fall below, and that should include all of the tools that are available to them to enforce the other standards that are set out——

Mr. LAFALCE. At least the sword of that enforcement.

Ms. GOLDBERG. It ought to be there for the cases where it is needed.

Chairman LEACH. Let me bring this to an end. I want to, first, just so there is an understanding, note that this bill is designed to reconfigure regulation for the modern world under the assumption that there are a lot of cracks today that exist. But, so there is no misunderstanding, we have to keep functional regulation. We try to keep a role for State regulation, and we try to keep a role for national regulation. We try to keep a role for State SIAs through the State SECs. Same for insurance, but only at the State level, but that is current law. On, for example, the issue of suitability, since the bill requires both the dealers that come under the SEC and it says suitability is covered, and it is intended to be.

Quite appropriately, you have alternative visions, and you have alternative bills, and some are designed to attract some, and some are designed to attract other interests, but I will tell you the bill the Chairman of this committee is bringing is designed not to allow a breach in commerce and banking. Alternatives in other bodies and in this committee have major breaches. I would hope the consumer groups of America would recognize that.

The bill that the Chairman of this committee is bringing closes down the commerce and banking unitary thrift loophole in terms of no more unitary thrifts; alternatives do not. I would think the consumer groups of America would find that not a small measure.

The bill that the Chairman of this committee is bringing calls for the regulator of the part of the American financial landscape that is now out of sunshine to have sunshine. I would hope that consumer groups would have some appreciation for that. There is also an effort to ensure that that part of the American financial system that is engaged with the CRA obligations stays healthy.

All of you recognize that when you have restraints with some and not on others, there is a tendency for those without restraints to go. This bill is trying to preserve a place in the sun for America's financial community that has a CRA obligation at a time period

where there is great diceyness about the future, and the alternatives of doing nothing are very, very harsh.

Finally, some of you have argued that the Federal Reserve Board should not be the regulator; but it should be put in terms of a politically-sensitive regulator. Well, I will tell you there is political sensitivity that goes very much the other direction, and if you look at the rulings of the office that you want to empower, as stipulated in this panel, they are not consumer-friendly rulings in many instances, and I think that there can be great protection in a professional regulatory apparatus.

I would just stress, we are in an international environment of enormous stress. At any moment in time, we could see a collapse of the financial system based on some of the things that Mr. Nader has talked about in terms of derivatives; based upon concerns that everybody is looking at. I happen to think that the Fed made a mistake in the Long Term Capital Management issue, but I also believe that the Fed is professionally better able to handle some of these problems than other institutions of Government and have the wherewithal to do something about a problem on a timely basis, and that it would be wrong to ignore the Federal Reserve Board in this regard.

In any regard, a number of very complicated issues exist in terms of framework and complicated subtleties. I think some of the concerns you have raised today have a degree of fairness that this committee is going to have to take into account, but I would also say that they haven't been totally ignored, and, as we go forward, I would just simply like to stress that the goal of legislation has nothing to do with enhancing the financial capacity of financial companies, but it has everything to do with serving the consumer of financial services. And that consumer, in a world in which bifurcations are getting larger and larger, as John Taylor stresses, has to be every American in the sense that you can't leave pockets of America totally outside the landscape or you end up with a society that gets to be bifurcated in very unfortunate ways.

Now, I will tell you we can't do everything for you, and I don't think you can expect that, but we will listen and will do the best we can within the constraints of what can realistically be accomplished. But I am hopeful that a bill that comes out will strengthen the American economy, and in strengthening the American economy that has massive consumer effects. The Secretary of the United States Department of the Treasury has suggested that the consumer will be saved $15 billion. That is a pretty big number in a pro-consumer circumstance that can't totally be ignored. What all of you are concerned about, and I would say Congress must be concerned about, is that there is not so much concentration that some of those savings do not go to the consumer, and that is something we are all going to have to be wary of. But things are happening in finance without this bill, the concentration direction, and what this bill is designed to do is basically manage it in the most credible way for the safety of the American economy. Thank you all.

Mr. LAFALCE. Could I have 15 seconds, Mr. Chairman?

Chairman LEACH. Yes.

Mr. LAFALCE. I just wanted to say that I share your statements with respect to basic banking provisions. That is not in my bill;

that is not in the Chairman's bill, but I guarantee you that it will be offered during the course of the markup as it was last year and that I think it would be extremely important to provide a model, not of consumer protection, but consumer promotion in the bill to deal with these 48 million who are more than $1,000 below or who have nothing, and I thank you.

Chairman LEACH. Thank you. The hearing is adjourned.

[Whereupon, at 4:45 p.m., the hearing was adjourned.]

H.R. 10—THE FINANCIAL SERVICES MODERNIZATION ACT OF 1999

FRIDAY, FEBRUARY 12, 1999

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON BANKING AND FINANCIAL SERVICES,
Washington, DC.

The committee met, pursuant to call, at 10:05 a.m., in room 2128, Rayburn House Office Building, Hon. James A. Leach, [chairman of the committee], presiding.

Present: Chairman Leach; Representatives McCollum, Roukema, Bereuter, Bachus, Royce, Lucas, Ryan, Ose, Biggert, Toomey, LaFalce, Vento, Watt, Bentsen, J. Maloney of Connecticut, Sherman, Lee, Goode, Inslee, Shakowsky, Moore, Gonzalez, and Capuano.

Chairman LEACH. The hearing will come to order. Today we continue on a third day of hearings on bank modernization legislation. We will hear from our distinguished Secretary of the Treasury, Mr. Rubin, who is joined by Assistant Secretary Carnell, and then we will hear from a panel of Federal banking regulators.

Let me just stress at the beginning that the hearings of the first two days have indicated there is greater consensus for moving toward bank modernization than I think has been registered before the Congress in recent years. It will be the intent of the Chair to move toward an orderly and timely markup, tentatively commencing on March 4th.

At the end of today's session, Congressman LaFalce and I will be issuing a joint statement indicating a desire to move forward with a committee markup with some compromises, recognizing that there will be a number of issues where there will remain differences.

In any regard, we are delighted to have the Secretary of the Treasury, who I think will go down as one of the most formidable and thoughtful Secretaries of Treasury in the history of the United States Treasury, Mr. Rubin.

STATEMENT OF HON. ROBERT E. RUBIN, SECRETARY, U.S. DEPARTMENT OF THE TREASURY, ACCOMPANIED BY RICHARD S. CARNELL, ASSISTANT SECRETARY OF THE TREASURY FOR FINANCIAL INSTITUTIONS

Mr. RUBIN. Mr. Chairman, Members of the committee, I greatly appreciate the opportunity this morning to discuss our views with respect to financial modernization, including H.R. 10, and H.R. 665 introduced by Mr. LaFalce this week.

With respect to the overall objective of financial modernization, the Administration has always been committed to doing what best serves the interests of consumers, businesses, and communities, while at the same time protecting the safety and soundness of our financial system, and we will support legislation that achieves those aims.

Let me begin by noting that the financial services sector in the United States is stronger and more competitive today than ever. Abroad, the United States is dominant in investment banking, highly competitive in other fields, and as strongly competitive in commercial banking as any time that I can remember in my career.

Financial modernization is already occurring, as you well know, in the marketplace through combinations of firms and also through the development of products in one sector functionally similar to products in other sectors.

Financial modernization will continue, in our judgment, in the absence of legislation. But with good legislation, financial modernization can occur in a more orderly fashion. The Treasury has long believed in the benefits of such legislation, but we also believe that any legislation has to be done right.

Let me also say, Mr. Chairman, though we favor financial modernization legislation, when you look at developments around the world over the last couple of years, the sorts of things that you and I were chatting about a moment ago, Mr. Chairman, the size of mergers that have taken place here in the United States over that same period, there are legitimate concerns about how financial modernization could affect economic concentration and systemic risk.

Let me turn now to the two bills before this committee. Both bills, H.R. 10 and H.R. 665, take the fundamental actions necessary to modernize our system by repealing the Glass-Steagall Act's prohibitions on banks affiliating with securities firms and repealing the Bank Holding Company Act prohibitions on insurance underwriting. Beyond that, however, there are significant differences between the two bills.

Today, I will focus on the concerns that the Administration has about H.R. 10. As you know, the Administration would have vetoed H.R. 10 had it passed in the last Congress, and we continue to oppose H.R. 10 in its current form. We have three basic objections to this bill: its prohibition on subsidiaries of banks conducting nonbanking financial activities; its weakening of the effects of the Community Reinvestment Act, CRA; and its expansion without reform of the Federal Home Loan Bank System.

First, the bill would prohibit financial services firms that include banks from conducting new financial activities through bank subsidiaries, and require that those activities be conducted exclusively through bank holding company affiliates. Subsidiaries and affiliates are absolutely identical with respect to the ability of a bank to transfer any subsidy that may exist in the bank. And subsidiaries and affiliates are absolutely identical with respect to safety and soundness, except in one respect, which I will discuss in a moment, in which subsidiaries are preferable.

The LaFalce bill, which allows banks to conduct merchant banking and securities activities through a subsidiary, contains the fol-

lowing rigorous safeguards that produce this result: Every dollar a bank invests in a subsidiary would be 100 percent deducted from the bank's regulatory capital, just as is the case with every dollar that a bank pays as a dividend to a parent holding company for investment in an affiliate. A bank would have to be well-managed and well-capitalized before and after such investment is deducted from its capital and on an ongoing basis. A bank could not invest any more in a subsidiary than it could pay as a dividend to its parent holding company for investment in an affiliate. The rules governing loans from a bank to a subsidiary would be exactly the same as they are for a loan from a bank to an affiliate.

Thus there are no public policy reasons to deny the freedom to choose either a subsidiary or the affiliate to conduct non-bank financial activities. However, there are four important policy reasons to allow that choice:

First, financial services firms should, like other companies, have the choice of structuring themselves in the way that they think makes the most business sense and this, in turn, should lead to better service and lower costs for their customers.

Second, the relationship between a subsidiary and its parent bank provides a safety and soundness advantage. Firms that choose to operate new financial activities through subsidiaries are, in effect, keeping those assets available to the bank rather than transferring them outside the bank's reach. If the bank ever needed to replenish its capital, the bank's interest in the subsidiary could be sold, solely at the behest of the bank. If the bank were ever to fail, the FDIC could sell the bank's interest in the subsidiary in order to protect the bank's depositors and the deposit insurance fund, which means the taxpayers.

For this reason, the FDIC, a neutral observer with a paramount interest in protecting the deposit insurance fund, its current chairman, and three former chairmen—two Democrats and two Republicans—have stated that the subsidiary option is actually preferable from the standpoint of safety and soundness and protecting the deposit insurance funds. I would also like to observe that currently, under the Federal Reserve's jurisdiction, foreign banks underwrite and deal in securities in the United States through subsidiaries, and U.S. banks conduct securities and merchant banking activities abroad through so-called Edge Act subsidiaries.

Third, to the extent that the firms choose to operate through subsidiaries, the consolidated assets of the bank will be larger than if these activities are conducted through affiliates, and that, in turn, is favorable with respect to the Community Reinvestment Act.

Fourth, one of an elected administration's critical responsibilities is the formation of economic policy, and an important component of that policy is banking policy. In order for the elected administration to have an effective role in banking policy, it must have a strong connection with the banking system. That connection is currently provided through the Office of the Comptroller of the Currency, which regulates national banks. We believe if subsidiaries of national banks cannot be used to engage in new activities, then gradually banks will gravitate away from the national banking system and this critical connection will be lost.

We also believe that it is very important that the Federal Reserve Board maintain its strong connection with the banking system. We believe that allowing banks the choice of conducting nonbanking financial activities, either through an operating subsidiary or an affiliate, serves the purpose of having both the elected administration and the Federal Reserve strongly involved in banking policy. And I will have an additional comment in a moment, Mr. Chairman, on another way that we think the Federal Reserve's position can be preserved.

With respect to the subsidiary option, we support three additional steps: First, we proposed last year—and the LaFalce bill includes—joint Federal Reserve-Treasury rulemaking to define new financial activities. We believe that this arrangement would promote consistency and would eliminate the potential for unhealthy competition in laxity in defining new activities.

Second, we favor functional regulation. We support provisions like those in the LaFalce bill, making clear that securities and insurance regulators have the same jurisdiction over subsidiaries as over affiliates.

Third, we have no objection to—and I think this is quite important—no objection to requiring the largest banks to retain a bank holding company, thereby assuring the Federal Reserve a central supervisory role regardless of whether the bank operates with affiliates or subsidiaries.

Our second major objection to H.R. 10 is its effect on the Community Reinvestment Act. CRA encourages a bank to serve creditworthy borrowers throughout the communities in which it operates. Since 1993, a greatly invigorated CRA has been a key tool in the effort to expand access to capital in economically distressed areas.

We believe that any bank seeking to conduct new financial activities should be required to achieve and maintain a satisfactory CRA record. The LaFalce bill includes that requirement, which we support. Although H.R. 10 requires a bank to have a satisfactory CRA record when it commences new financial activities, it does not require that the bank maintain a satisfactory record. If we wish to preserve the relevance of CRA at a time when the relative importance of bank mergers may decline and the establishment of nonbank financial activities may become increasingly important, the authority to engage in newly authorized activities should be connected to a satisfactory CRA performance on an ongoing basis.

Our third major objection to H.R. 10 relates to the Federal Home Loan Bank system. The FHLB is currently the largest issuer of debt in the world. Yet the system uses little of its Government-subsidized debt to further the system's original homeownership purpose.

We recognize the desire of many members to see the system lend more to community banks. Indeed, we believe that the system should focus on such lending, and not on using taxpayer funds for arbitrage activities and overnight lending which currently constitute so much of its activities. Changing this important system perhaps should be done separately, but if it is to be addressed in this legislation, we believe that changes in the FHLB system should occur only in the context of comprehensive reform.

Let me mention briefly two other areas of H.R. 10 where we have concerns. First, we believe that the current law on bank insurance sales is pro-competitive and pro-consumer and is preferable to H.R. 10's provisions, especially with respect to establishing safe harbors and restricting deference. Second, although creating wholesale financial institutions may be an appropriate step, we believe that developments in financial markets over the last couple of years raise serious concerns that need to be considered.

Before concluding, I would like to say a few words about H.R. 665, the LaFalce bill. As I announced on Wednesday, we support the LaFalce bill. The LaFalce bill allows firms the subsidiary option, preserves CRA, avoids anticompetitive restrictions on bank insurance sales, and omits other provisions of H.R. 10 that in our opinion do not advance the cause of modernization. However, we support this bill with the caveat that we have serious concerns about the affiliation between commercial firms and depository institutions which this bill would permit.

Mr. Chairman, to conclude, let me reiterate: Our Nation's financial institutions are strong and highly competitive, both here and abroad. In our view, financial modernization legislation can produce significant benefits, but the job must be done right. We in the Administration look forward to working with you and others in Congress more broadly to construct good financial modernization legislation that serves the interests of consumers, businesses and communities, while protecting the safety and soundness of our financial system. Thank you, Mr. Chairman. The two of us now would be delighted to respond to questions.

[The prepared statement of Hon. Robert E. Rubin can be found on page 687 in the appendix.]

Chairman LEACH. Thank you.

Mr. Carnell, did you want to make an opening statement?

Mr. CARNELL. No, thank you, Mr. Chairman.

Chairman LEACH. Well, first let me just say we certainly welcome your appearance and recognize there are differences of judgment on certain aspects of the approach before Congress. One of the frustrating aspects of this bill, as everyone knows, is that there are differences between and within industrial groups. There is also a difference between and within the Administration on the issue of regulation.

At the end of Chairman Greenspan's presentation, I asked if he would be willing to meet with you and appropriate Members of Congress to help work this out and he affirmed that he would. Is that likewise your situation?

Mr. RUBIN. The answer to that question is yes, Mr. Chairman, if I could say one comment. The Federal Reserve Board and this Treasury have had a remarkable relationship. People who have been around a long time have not seen anything like the close relationship that we have had, and I think it has been a great benefit to the country across a broad array of issues. This is an area in which we have agreed to disagree. We have discussed it many, many times. We are each in the position that we are in. But having said that, if you would like us to get together with you, we would be delighted.

Chairman LEACH. I think that the Congress would certainly feel most comfortable if there is a meeting of the minds between the Executive Branch—and that doesn't mean that Congress would ever give carte blanche to such a meeting if it did occur, but I think that the resolution of this issue involves many, many nuances, and the last thing that I want to see precipitated is a circumstance where we have a Treasury-Federal Reserve Board cataclysmic rupture. The fact that at various points in time there has been unwillingness to discuss the issue on a mutual basis is disconcerting. I think it would be good for the Congress, as well as good for the public at large, to have this occur.

We had Chairman Greenspan express the view on this one subtle issue of the operating subsidiary that he could not support this bill if it came up a different way. We have the Secretary of the Treasury articulating before this committee that he would recommend a veto of the bill if it comes up the other way. That is a dilemma of fairly profound significance, given in particular the fact that structurally speaking, both approaches work, as well as points in between work.

That being the circumstance, it strikes this Member, and I think I frankly speak for many on this panel, although I always hate to presume on anyone else, that there is an element of frustration. It was reflected by industry groups or industry individuals who testified before us as well.

And so I am hopeful something can be done. And that is all I am suggesting, as strongly as I can, and I am hopeful that we can get out of the element that we get two very strong individuals, as well as two very strong institutions, outside the realm of conflict on this very substantial and important circumstance.

Mr. RUBIN. Could I just say one more thing? You used the term "cataclysmic rupture" between the two institutions. Let me assure you we have lived with this difference for over a year now, and we continue to have an extraordinarily good working relationship. My guess is, having discussed this many times with Chairman Greenspan, that there is not a place that we can both get to, but I am confident that our very good working relationship in all other respects will continue unaffected.

Chairman LEACH. Thank you.

Mr. LaFalce.

Mr. LAFALCE. First of all, I want to thank the Chairman of the committee. We had a meeting this morning where we just agreed to agree as much as we potentially could, and agreed to disagree agreeably on those areas where we do disagree. But I think it was very, very productive in setting the tone and I look forward to working with him. We are both committed to producing good modernization legislation and we would like to come as close together as we possibly can. And when we can't, we will vote different issues up and down and draw final conclusions at the end.

I also want to congratulate the Secretary of the Treasury, too, and commend him for being so conciliatory and bending over backward to find something that might be acceptable to the Federal Reserve Board on this issue. Certainly, Treasury came a long way before I introduced my bill along with Congressman Vento and Con-

gressman Baker and Congressmen Mascara and Ackerman and others, cosponsored yesterday by Congressman Dreier also.

And in your testimony today you have gone even further in the spirit of compromise, in making the statements as to what you could live with. They go even further than our bill has gone, bending toward the Federal Reserve Board. So I just wanted to make that point. I thank you for it.

Mr. Chairman, I have an article giving a certain perspective on the issue of the so-called subsidy. It is entitled "Exploding the Myth" and I would like unanimous consent to insert it in the record.

Chairman LEACH. Without objection.

[The information can be found on page 636 in the appendix.]

Mr. LAFALCE. Thank you. And now if I could just ask a few questions, Mr. Secretary, a combination. Yesterday, Chairman Greenspan referred to our concepts of operating subs creating a universal bank, and I think that is a bit in error. I would like you to give me your thoughts on that. And also I would like you to tell me if we have any experience with banks using subsidiaries, or is this a new idea? Both of those questions.

Mr. RUBIN. OK. On the first one, Mr. LaFalce, universal banks are a European concept. That is not what we are proposing. Universal banks, as I understand them, conduct non-banking activities directly or through subsidiaries that they fully fund. There are no funding restrictions. That is my understanding of how the universal bank works. That is not, absolutely not, our proposal—your proposal.

Your proposal is that whatever can be done in the subsidiary in terms of equity investment or loans is no greater than what can be done in an affiliate. And as I said in my opening statement, if there is going to be an equity investment by the parent in the subsidiary, that can be no greater than the investment that can be made in an affiliate and has to be 100 percent charged against the capital of the bank, just as it would be if the bank paid a dividend and the holding company put it into the affiliate. And, furthermore, loans to the subsidiary cannot in any way be greater than and must be done in precisely the same way as loans to an affiliate. So there is a total identity between the affiliate and the subsidiary. These are very substantial restrictions, and they are the antithesis of how the universal bank works.

Mr. LAFALCE. And what about experience? Is the concept of an operating subsidiary a new idea or is this something that there is some historical experience that we can look to?

Mr. RUBIN. There are at least two situations in which this exists right now. The Fed will permit an American bank to conduct non-bank financial activities abroad in what is called an Edge Act subsidiary, and that is subject to Fed jurisdiction. And the Fed also has jurisdiction over foreign banks that wish to conduct non-bank financial activities in this country. The Fed has approved something like 18 of these applications to conduct so-called Section 20 activities, through subsidiaries.

Mr. LAFALCE. And that is not even taking into consideration the experience of operating subsidiaries for State-chartered banks, and I think there are a great many States that have specifically legisla-

tively authorized this, and some bills would preempt that State law and obliterate what States have long permitted; is that correct?

Mr. RUBIN. That is correct. The reason I mentioned the two I did, Mr. LaFalce, is that those two involved Fed jurisdiction and Fed approval. But what you said is correct.

Mr. LAFALCE. Thank you.

Chairman LEACH. Thank you.

Mr. McCollum.

Mr. MCCOLLUM. Thank you, Mr. Chairman.

Mr. Secretary, I think it was on Wednesday, the Community Bankers were not surprising us, but they expressed a strong desire to close the so-called unitary thrift loophole. The LaFalce bill doesn't address that. Do you have a view on it?

Mr. RUBIN. Well, our view, Mr. McCollum—and it is a view that I think has been affected by the experience of the last couple of years—our view, and I stated to some extent in my opening statement, though not with the clarity that you are posing the question—our view is to have very serious reservations about any combination of depository institution and commercial activity, and that would include continuing to go forward with unitary thrifts.

We do think that the resolution that you reached last year on H.R. 10, the—allowing them to exist, but on a grandfathering basis, but not permitting them to go forward, seemed like a reasonable resolution. But I think there are a lot of reasons to have serious reservations about this combination.

Mr. MCCOLLUM. What do you think about the suggestion of allowing the existing unitary thrifts to be sold to other entities without allowing any new unitary entities to be formed? That is a topic of hot debate.

Mr. RUBIN. I gathered. Let me make sure I understand the question and I will give you my view. You are talking about an existing unitary thrift holding company?

Mr. MCCOLLUM. That is right.

Mr. RUBIN. Being sold to some other commercial entity?

Mr. MCCOLLUM. That is right. As they are now permitted.

Mr. RUBIN. As they are now permitted. I guess to me that raises a lot of the same questions. I think that anything that enables a broadening of the relationship between depository institutions and commercial activity, I think raises the same kinds of very serious concerns that I mentioned a moment ago.

Mr. MCCOLLUM. So you would prefer to allow the ones to exist that exist, but you would freeze them in place in all respects, in essence, not allowing new ones to grow and not allowing old ones to be transferred or sold?

Mr. RUBIN. As I understand, that was the resolution that you all reached last year.

Mr. MCCOLLUM. That was the way the bill read, although there was a lot of debate over that and there still is a lot of debate over that. Thank you for that. Let me ask you about the question more explicitly, too, on commerce and industry. I know the answer based on what you are saying. Do you support the 15 percent commercial basket in the LaFalce bill?

Mr. RUBIN. We would, again for the same reasons, have very serious reservations.

Mr. McCollum. What about the definition that Mr. Greenspan gives us of "subsidy" in terms of banks? He says the fact that banks have deposit insurance, access to the payment system, and the discount window, creates a subsidy which means that banks can raise funds more cheaply because of their Government benefits.

Is that—do you believe that is true? Not getting into the question of whether or not you think we ought to have this done in subsidiaries.

Mr. Rubin. Two comments in response to that question. One, they may well be subsidies. I think it is a little less clear than the statement you just made, because they do pay for insurance and they are subject to regulations and those regulations have costs. So I think it is little less than absolutely clear that they have a subsidy, but they may well have a subsidy.

And I guess my other reaction is that it is very hard to know what to compare a bank to. For example, if you compare it to a finance company with the same rating you may say the bank's financing is cheaper and that is probative. I guess my answer would be that finance companies are in very different businesses than banks. So it is very hard, I think, to infer subsidy from differences in cost of money between institutions that are engaged in somewhat or in many cases quite different businesses.

Mr. McCollum. But would that so-called subsidy give an advantage to a bank in terms of competition in the future if we have more powers or more—you know, insurance, and securities and so forth, as opposed to a business in that area that doesn't have any affiliation in any way with a bank?

Mr. Rubin. If, indeed, there was a subsidy—and for the reason I just said I think there may be, but I am not absolutely clear there is—if there is a subsidy, then that obviously is a subsidy that a bank can use to get some competitive advantage. And I will add, if I may, that has nothing to do with the question of an op-sub or affiliate that can be transferred to either one.

Mr. McCollum. You got to the last question and I don't have to ask it, and I will yield back to the Chairman. Thank you.

Mr. Rubin. You did it in a very orderly way, though.

Chairman Leach. Mr. Vento.

Mr. Vento. Thank you, Mr. Chairman.

Mr. Secretary, we appreciate your positive participation and notwithstanding your efforts to try and reconcile this, the answer in this morning's paper and yesterday didn't seem to come back very conciliatory. In any case, my observation, not yours. We know where we are. I think the issue is if regulators can't agree, we can obviously move forward on this issue. I think it is an issue that we would prefer to have some agreement on or, as we put it, some comity.

One of the issues here is, with the umbrella regulators, there are a number of instances where insurance individuals—we have passed a lot of the decisionmaking role to the Federal Reserve Board. We call it "Fed-lite," but it is like lite beer. It makes you feel good because you are taking in fewer calories, but just as potent in terms of the amount of alcohol that is in it. This is sort of like the umbrella regulator.

In light of the fact that in the past some of the Federal Reserve Board Governors have lamented about the amount of bank regulations and responsibilities which Congress has given them, the fact is that—I mean, the question that has to be asked is whether or not adding these additional responsibilities, whether they are "Fed-lite" or whatever, are in fact going to be—how they are going to be exercised?

Are you satisfied with the concerns—for instance, some of the insurance, State insurance regulators suggest that the Fed, in terms of defining the responsibilities between an affiliate, an insurance affiliate and a bank affiliate, would define the nature of the instruments without guidance. Do you think we should have more guidance in the bill, and do you think that Treasury has enough voice in the case of defining these various instruments?

Mr. RUBIN. We support a strong Fed involvement in bank regulation, and I said that in my statement. I think in terms of the second-to-last issue you raised, it seems to me an appropriate way to deal with that kind of issue is with joint rulemaking between the Fed and the Treasury.

Mr. VENTO. I agree that so far as we can do that, I think it is appropriate. One of the issues yesterday—what we are doing is sort of redefining or rewriting history, and I wanted to get your view on this. The issue was brought up about First Option and Continental Illinois. The problem that First Option had with regards to the sub, putting—the affiliate putting in money, and the OCC had ordered a cease-and-desist order and the Federal Reserve Board actually ordered money to continue to be pumped in through the affiliate. How do you see that particular problem and what do you think the remedy is to that?

Yesterday, of course, we had the Fed describe the problem as the problem of the op-sub, and using it as Exhibit A that the op-sub was the problem. In reviewing this more closely, by the time we got to the afternoon and the Chairman had left, it was pretty evident that the Federal Reserve Board had been involved as to avert problems in the market, and I don't discourage them from averting problems in the market. We saw that with Long-Term Capital recently, although they claimed to have done nothing more than bought the sandwich and the coffee, the fact is that most us think they may have had a little different role in terms of it.

Would you like to comment upon not just this type of intervention, which I think both of us might agree in a mixed economy is not a bad idea, but as to whether or not one of these governance structures one of these corporate structures is superior to the other?

Mr. RUBIN. Mr. Vento, on the question of Continental Illinois-First Option, I actually remember that somewhat. That was I think on October 19th, 1987. In any event, on the basic question of whether there was a scintilla of difference between an op-sub or an affiliate in that kind of situation, the answer is no.

If an op-sub very rapidly gets in serious economic trouble and starts generating very large losses, the op-sub can be liquidated, sold, divested. As soon as it is divested—and this gets a little technical, I know, if the bank's books reflect any losses beyond its equity investment in the subsidiary, those will be reversed. In the

final analysis, there will be no equity loss in the bank because the equity that has been invested by the bank in the op-sub has been 100 percent charged off against the capital of the bank, so there is no more that can be lost.

If there have been some loans from the bank to the subsidiary that go bad, the result will be precisely the same as—identical to what would have happened had the activity been done in an affiliate. Because there, too, there can't be any more loss on the equity, since that has been 100 percent charged against the bank's capital. And if there is a problem with the loan, that loan is no different, zero different, than the problem with the loan to the subsidiary, since they are both made subject to Section 23(a) of the Federal Reserve Act.

Mr. VENTO. One additional question. Federal Reserve Board Governor Meyer has lamented the fact that we have in the Interstate Banking and Branching Law a 10 percent limit on the total size of assets—I think it is assets or deposits—with regard to total assets in the financial institutions in the country with regards to banks. In fact, Nations has pushed up to 8 percent. When we wrote this into the Interstate Banking and Branching Law, I don't think anybody exceeded 2 or 3 percent.

I know you commented in your opening statement about the mergers and the growth of institutions. And so my—I don't know if you are prepared to talk about this this morning, but you are concerned about the 10 percent limit?

I just would suggest to you that myself and others on the committee here wrote that into law, the 10 percent limit. You talked about mergers and acquisitions, so I would like your views on that.

Mr. RUBIN. It is 10 percent of nationwide deposits, I think, Mr. Vento. I haven't thought about it. It is a good question. I have not thought about it in terms of that law. My comment was that as you see aggregations of economic assets, particularly in the financial services sector which is so central to the economy, you can begin to have concerns about undue concentration, but I didn't relate the concerns to that statute.

Mr. VENTO. I think it is important because I do think it is something that is coming up, and obviously from our constituencies we are getting feedback from this and what the evolution is going to be in terms of the concentration and the lack of relationship in terms of services, which I think gets back to why we need strong consumer provisions in this bill as well.

Mr. RUBIN. I do think on the LTCM case which you asked me about, I do think that the Fed acted—I am no great expert in it, but based on everything I know about it I do think that the Fed acted appropriately and usefully.

Chairman LEACH. Mrs. Roukema.

Mrs. ROUKEMA. I guess I must say, Mr. Secretary, that in answer to one of Mr. Vento's questions you went very quickly through your explanation of how it really didn't make a difference and none of the things that the Fed is saying about the capital standards between the affiliates and the operating subsidiaries hold weight, but I think you went through that a little too quickly. But we will go through your testimony and get the refutation.

I want to explore a different aspect of this issue. Needless to say, I am more favorable to the holding company structure than the op-sub. But we have talked—you have talked extensively, as have we both here today and with Mr. Greenspan, about compromise, and you have suggested joint rulemaking as one aspect of that compromise.

I wish you could be a little more explicit about that. But in the context of my concern that there is far more to this than just turf, as I am convinced, I am also concerned that, as you pointed out, the question of the Administration and your argument, the Administration and the OCC being very concerned about the economic health of the country and that is one of the leading reasons why you believe you should have more authority here, I see the reverse. I see the other side of that coin, however, as being a potential for political manipulation, and that has been rampant in many of the European, certainly the Asian countries in their system. It has been so interrelated to the ruling government.

So I wonder if you can respond to that question. Yes, we are looking for compromise, but not a compromise that is going to compromise the basic principles here that we are talking about, and not one that would invite political manipulation of the system.

Mr. RUBIN. I think it is a good question, Mrs. Roukema, and I think particularly if you look at what has happened in some of the Southeast Asian countries, you cannot help but ask that. The reason for my fast answer to Mr. Vento's question was not a desire to be obfuscating, it was just that you have a five-minute rule. I could go on, if the Chairman would give me an hour.

Mrs. ROUKEMA. With all due respect, I understand that, and I will go over the testimony, surely.

Mr. RUBIN. But on your question, I think there are a number of distinctions that need to be made. One, if you take a look at what happened in Southeast Asia, a lot of the trouble actually came from an unhealthy nexus between the banking system in industrial countries and what I would call industrial policy, if you will, in the central government. It is one of the reasons why we have very serious concerns about the banking and commerce issue or more generally depository institution issue here.

In terms of politics, whether it is appropriate for the elected Administration to have a role in bank policy, I would break this into two pieces. With respect to supervision, we are prohibited by law from getting involved in case-specific matters, such as supervision of banks. With respect to broader banking policy, I don't see that as being any different than economic policy more generally or transportation policy or foreign policy or anything else.

These are all very important to the country, and certainly an elected Administration's position with respect to its full range of responsibilities can be used properly or misused, and I think it is the responsibility of people in elected office to use it properly. But it is possible for an Administration to badly misuse its accountability and responsibility for transportation policy.

Mrs. ROUKEMA. That is a little different. But could you comment further on the joint rulemaking, how you would see that as operating in practical terms?

Mr. RUBIN. I think certainly one of the questions that will arise is, what is a non-bank financial activity? And my guess is you are going to see all kinds of hybrid things that are going to have to be decided. Rather than have the Fed do it for the Fed and the Treasury or OCC do it for the OCC, which has a number of potential problems associated with it, it seems to me what you should do is have the Treasury and the Fed sit together, as we do in a number of other areas now, and decide what these definitions should be. I think that is the way to avoid a lot of the problems that come from competing regulatory bodies.

Mrs. ROUKEMA. Can that be written into statute?

Mr. RUBIN. I think it could be. We would be glad to work with you on it.

Mrs. ROUKEMA. Thank you. I yield back.

Mr. RUBIN. One of the other things that does strike me is on this question of whether elected administrations are properly performing their role with respect to any policy, including bank policy, we also have IGs and congressional oversight and GAO, so there is a whole body of oversight that is built in to try to make sure that that happens.

Mrs. ROUKEMA. Thank you, sir.

Chairman LEACH. Mr. Watt.

Mr. WATT. Thank you, Mr. Chairman.

Let me start by first complimenting the Chairman, again. I think this three days of hearings has been inordinately beneficial, perhaps even more beneficial to those of us who have been around and heard this debate one time before, because we have some context within which to put it. I am not sure how beneficial it has been to those who have been around and heard it 15 times, but for one of who has heard it only two or three times I do think it helps a lot.

Mr. Rubin, I have been an advocate of your position and Mr. LaFalce's position on the op-sub issue and because of the impact that I think it would have on CRA. I understand that aspect of it. But there is one little part of it that troubles me a little bit, that I need some clarification on. On page 3 of your testimony, the second point you make is that firms that choose to operate new financial activities through subsidiaries are, in effect, keeping those assets available to the bank rather than transferring them outside the bank's reach.

And, of course, that is true of assets. I take it Chairman Greenspan's position is that it would also be true of liabilities, not just assets, and that is what creates the potential for problems. Can you address that a little bit and help me understand why, if the bank retains the assets, that is beneficial, obviously, but why doesn't it also create the risk that are associated with the liabilities?

Mr. RUBIN. You are talking about this safety and soundness issue here?

Mr. WATT. Yes.

Mr. RUBIN. Sure. And I think that is very central to this discussion. What fundamentally happens is that the bank can decide to do this, as you know, either in the op-sub or in the affiliate. Under the provisions in Mr. LaFalce's bill, whatever equity investment

they are going to make in the subsidiary, they have to charge 100 percent against their capital, so there is no possible further loss there. That would be exactly the same if they made a dividend to fund the affiliate. If they wanted to extend any loans to the op-sub, they have to do it in accordance with Section 23 of the Federal Reserve Act, precisely the same section that would control loans to an affiliate, so there is no difference there.

If they, however—here we get to the difference—and also they have to be well-capitalized before and after they do this, and maintain that on an ongoing basis, and well-managed. Here is where the difference lies. If this entity does well, if it is successful, then the bank has an asset which, if the bank gets in trouble, can be used to satisfy either the creditors of the bank or the FDIC. And that is what I said in my opening statement, why the FDIC and its president and three former chairmen say it is preferable to the affiliate.

If the subsidiary loses money and gets into trouble, which is the example that was brought up before, then that will not put the bank in any worse position than it would if the affiliate got into trouble, because what the bank can do is simply liquidate. Say the liabilities you talked about overwhelm the assets. Then the bank can simply liquidate or dispose of or divest the subsidiary, and any losses that have been taken on a consolidated basis in the bank get reversed. If there was any diminution of capital in the bank as a result of those losses, that gets restored under GAAP accounting rules, and the bank will be in precisely the same position as they would have been had all of these problems developed in the affiliate.

Mr. WATT. I need to study that a little bit more.

Mr. RUBIN. What I think we may do, since you and somebody else raised the same question, I have forgotten whom, maybe it was Mr. Vento, maybe Mrs. Roukema, I think we will do a little letter on this maybe. Because it is complicated and I think we can lay it out and we will.

Mr. WATT. That would be helpful. Let me ask one other question. You talked about these two instances——

Mr. RUBIN. And as you know—I apologize.

Mr. WATT. You are not going to let me get this question in, are you? I was trying to do it before the red light.

Mr. RUBIN. Under corporate law the parent is not responsible for the liabilities of the subsidiaries. Go ahead.

Mr. WATT. I am not sure the Chairman is going to let me ask it now.

Chairman LEACH. Mr. Watt, you have been the most diligent Member of the committee at these hearings.

Mr. WATT. You are going to be kind and give me back that half-minute that I spent praising you at the beginning of my comments?

Chairman LEACH. Please, go ahead.

Mr. WATT. I am looking for additional areas of compromise here. And the reason I want to put this question out here, the two instances that you referred to—I don't know anything about the Edge Act, whatever that is, and the other instance that you referred to where this same kind of op-sub arrangement is going on, in both

of those instances I thought I heard you say this application now has to be made to the Fed and the Fed passes on those.

The question I am asking is might that be an area of compromise on this op-sub issue, where an application would be made to give the capacity to do an op-sub that would be passed on not necessarily by the Fed by itself, but by the Fed and Treasury, by the Fed and OCC. Might that be an area where there could be some kind of compromise on this issue?

Mr. RUBIN. I think not in the form that you have just—what you said is right about the Fed having jurisdiction over the two situations. I don't think in the form that you just said it, it could work, Mr. Watt, because given the Fed's views on op-subs, if they had exclusive jurisdiction you wouldn't get a lot of approvals. I suppose if you said there would be joint approval for both affiliates and op-subs, that might be a possibility. I hadn't thought about it.

Mr. WATT. You would have a kind of a standoff there. You might not have any op-subs or affiliates.

Mr. RUBIN. No, because we believe that you should have a freedom of choice and do it equally in both. We wouldn't have a problem.

Mr. WATT. You might hold up an affiliate application, put pressure on the op-sub application, maybe?

Mr. RUBIN. I haven't thought this one through, and it has its aspects, I suspect.

Mr. WATT. I will just put that out there as another possible area of compromise. I yield back. Thank you.

Chairman LEACH. Thank you, Mr. Watt. Before turning to Mr. Bereuter I would like to ask unanimous consent that written testimony be submitted for the record by the Banker's Roundtable and the National Association of Independent Insurers. Without objection, so ordered.

[The information can be found on page 874 in the appendix.]

I would also like unanimous consent to submit for the record witnesses' questions from Mrs. Kelly, who is out of the country today, and would be appreciative if you could respond to those in writing.

Mr. Bereuter.

Mr. BEREUTER. Thank you, Mr. Chairman.

Mr. Secretary, thank you for your testimony and your responses here. I was pleased to hear your views once again on mixing commerce and banking. Mr. McCollum asked the two questions I had uppermost in my mind, but a third area where you have criticism of H.R. 10 relates to the Federal Home Loan Bank system, and I don't think that has been much explored. As you may know, this is one of the areas that has some interest and appeal to small bankers.

You indicate the system uses little of its Government-subsidized debt to further the system's homeownership purposes. I think that is a very important concern. You go on to say that you think that any changes in the system could occur only in the context of comprehensive reform.

Mr. Baker, my colleague from Louisiana, has been very interested in this kind of comprehensive reform for some time. I have not been privileged to serve on that subcommittee, so I don't know to what extent the Treasury has expressed its interest or concerns

about comprehensive reform. But would you say a little bit more about this and, in fact, has the Treasury done anything in writing as a critique of the failure of the homeownership function to be pursued adequately by the system? Could you enlarge a little bit on your concerns with H.R. 10 in this respect?

Mr. RUBIN. Let me do that, if I may, Mr. Bereuter, and then ask Assistant Secretary Carnell if he would like to add in. We think there are important functions the Federal Home Loan Bank System can serve. Our problem is that the system, as you know, enjoyed a subsidy via the market perception of an implicit guarantee by the Federal Government. And that subsidy, that difference in the cost of borrowing, is basically absorbed by the taxpayers, even though it is a contingent liability, rather than annual appropriation.

And in our judgment, that subsidized capital ought not to be used for overnight loans and a vast arbitrage portfolio, as is now the case, but rather for specific socioeconomic purposes that Congress prescribes by law. It seems to us community banks are one good place to do that. Dealing with distressed communities is another good place to do that. And there may well be others. And homeownership obviously, although securitization has probably removed much of the need there.

But right now, an enormous amount of that subsidized capital is used for overnight loans and arbitrage, and in our judgment there is no reason in the world why the taxpayer should subsidize that.

Let me also make clear this debt is not—not—backed by the United States Government, but it is viewed in the markets as having some kind of implicit guarantee. That is the risk they are taking.

Rick, do you want to add anything to that?

Mr. CARNELL. Certainly. Mr. Bereuter, we testified some months ago before Mr. Baker's subcommittee, and we would be glad to provide copies of that testimony. We focused there on the Home Loan Bank System's investment arbitrage portfolio. The Secretary has already referred to our belief that that portfolio needs to be substantially curtailed.

Just a few more thoughts relating to comprehensive reform. Another key element of such reform, as we see it, would be to closely link the system's activities to its public purpose. And I would submit that if that is done, the system will also become more responsive to community banks than it is now.

Mr. BEREUTER. Could you be explicit about some suggestions about how that could be done?

Mr. CARNELL. Yes sir, we can be more specific in follow-up, but let me point now to one of the clearest examples of a failure to have a link between the system's activities and public purpose. This example would be in addition to the arbitrage portfolio.

If you are a bank, you can join the system by just having a certain amount of mortgage-backed securities in your portfolio for an instant of time when you join. After that, you need not make a single housing-related loan or hold one in portfolio or do anything else, and you can still be a qualified member of the system until the end of time. You need not do anything that furthers the system's public purpose. And as long as you can present acceptable

collateral—which, for example, would include Treasury securities, which have no particular connection to housing—you can borrow from the system and use the money for any purpose that your charter allows.

So that is a generic Government subsidy. There is no connection to a public purpose. And what we have suggested is that advances be limited to some proportion of the housing or other mission-related loans that the institution has on its books.

Mr. BEREUTER. Thank you.

Thank you, Mr. Chairman.

Chairman LEACH. Thank you very much.

Mr. Bentsen.

Mr. BENTSEN. Thank you, Mr. Chairman.

Mr. Secretary, yesterday—there are two things which you may or may not know. Yesterday, one, I floated the idea of a compromise to Mr. Greenspan that the regulation of bank holding companies be transferred to the OCC and we drop the whole idea of operating subsidiaries, but he demurred on that. The other thing that he said which I think you are aware of, and I think it is important to restate, is Mr. Greenspan reversed his position on safety and soundness as it related to operating subsidiaries as compared to what he had told this committee two years before. Two years before in response to questions that I asked and others, he said the whole question of operating subsidiaries had nothing to do with safety and soundness, but he told us yesterday upon reflection with members of his staff over the last year, he has now rethought that issue and believes that perhaps there is a safety and soundness question.

Mr. Greenspan also on this question of the subsidy in response to a question I asked tried to draw a line for us, and I agree—first of all, let me say I agree with your contention that the market doesn't define a differential in a subsidy between a holding company and a subsidiary, and I trust your judgment on that from your years in the capital markets and we asked one of your former colleagues with Merrill Lynch as well as someone from J.P. Morgan the other day and they seemed to feel that the capital markets were adequate in determining the true value of an asset without some implicit subsidy because it had "bank" next to its name. But Mr. Greenspan tried to draw for us a picture that said the difference between a holding company and a subsidiary and whether or not you had risk in transferring value out in the form of a dividend up to the holding company or down to the subsidiary, he argued there was a difference because the bank would send less in dividends to the holding company in order to maintain a better balance sheet in the bank versus what they would do with the operating subsidiary and thus that would create a subsidy with this operating subsidiary versus the holding company. It sounded odd to me. It would seem to me and, from your experience out of Treasury, wouldn't you assume that a well-managed holding company would transfer as much out in dividends to its shareholders as it would through a subsidiary?

Mr. RUBIN. I guess my view, Mr. Bentsen, is that is a business decision that the institution would have to make, but I don't see any reason why they would transfer more to an op-sub. If you are saying that the suggestion was that more would be transferred——

Mr. BENTSEN. More would remain in the bank with an operating subsidiary in order to build up the excess capital in the bank for the benefit of the bank, thus enhancing the subsidy to the operating subsidiary than you would otherwise with an affiliate.

Mr. RUBIN. My instinct is to think that if an institution is going to build non-bank financial activities, then they are going to have a business plan or strategy, and whether it is an op-sub or an affiliate is not going to make a difference in how much they transfer out. Having said that, I must say if they do in fact preserve more of their assets in the bank than would otherwise have been the case, then the bank will be a safer and sounder institution with the op-sub than it would have been with the affiliate. My instinct is to think there would not be a difference. But if there is a difference, it argues in favor of the op-sub as creating greater safety and soundness.

Mr. BENTSEN. Thank you. The other question. Could you explain for us, yesterday in his testimony Mr. Greenspan argued that in fact moving to an operating subsidiary structure, or, rather, not having an op-sub but having an affiliate structure would in no way reduce the number of assets under regulatory authority of the Treasury or the OCC and in fact he argued that those assets have risen over the years. Could you explain for us how Treasury would view the world if we passed a financial modernization bill that only allowed for an affiliate structure. How would you perceive national banks would act with a change to a holding company structure? What is your view of the world in the event that there is no operating subsidiary and what is the problem with that?

Mr. RUBIN. I think there are two issues there. One is that it is our judgment that if you now permit non-bank financial activities, these activities will become important for banking organizations. But if they cannot do it with a national charter, then the national charter will lose a great deal of its value. If the national charter loses a great deal of its value, then all other things being equal, it seems to me that over time banks will gravitate away from the national charter. Why have two regulators—inevitably with a holding company and with a bank, they are going to have the Fed as a regulator anyway—why have two regulators when you can gravitate to having one?

Second, as you know the OCC charges for its examinations and the Fed does not. The Fed uses the taxpayer moneys that they earn on their bond portfolio. So there is a disadvantage in having a national charter. But it is a very good charter so a lot of banks now use it. If the national charter were disadvantaged by being precluded from having these non-bank financial activities, then I think over time you would have a very substantial gravitation away from the national charter, the national charter would lose much of its value, and the Nation would lose the various benefits of allowing structural choice that I have mentioned before.

Mr. BENTSEN. Thank you. Thank you, Mr. Chairman.

Mr. RUBIN. Including the safety and soundness and real viable options for businesses to choose whatever structure they like best.

Chairman LEACH. Thank you, Mr. Bentsen.

Before turning to Chairman Bachus, I would like to make an announcement that we are visited at the moment by a group of par-

liamentarians from the country of Iceland. I would like if they could stand, Mr. Egilsson, Mr. Einarsson, Mr. Haldorsdottir, Mr. Sigfusson and Mr. Gestsson. We are honored you are with us.

For those from non-Scandinavian backgrounds, perhaps it should be stressed that next year is not only the new millennium in one sense, but it celebrates the millennium since Christianity was introduced to Scandinavia and since Leif Ericsson, I am sorry, Mr. LaFalce, discovered the New World. We are honored that our Icelandic friends are here. I must say to my mother's dismay, who was Norwegian, Leif was an Icelander whose father came from Norway. We are honored you are with us and welcome.

Mr. LAFALCE. Mr. Chairman, I want to associate myself with your remarks of welcome. On the other hand, I remember the remarks of Chairman Frank Anunso. He said, "Leif Ericsson discovered America, but Christopher Columbus kept it discovered."

Chairman LEACH. Mr. Bachus.

Mr. BACHUS. Thank you, Mr. Chairman.

Secretary Rubin, it seems like this whole thing about operating subsidiaries versus holding companies, there are two separate issues. One is, is there an unfair subsidy, and the second one is the safety and soundness. Mr. Watt and Mr. Bentsen have sort of talked about safety and soundness. My question is this: when you determine the safety and soundness of a bank, you look at the balance sheet, do you not?

Mr. RUBIN. That is certainly one of the things to look at, yes.

Mr. BACHUS. I mean that is an important thing to look at?

Mr. RUBIN. It sure is.

Mr. BACHUS. A lot of it, the accountants go in and the examiners and they look at the balance sheet. Now, under generally accepted accounting principles, a direct subsidiary's assets and liabilities are attributed to the parent. Is that right?

Mr. RUBIN. They would be consolidated with the parent.

Mr. BACHUS. Because of that, just because that is a part of our accounting practice, in the case of a bank if you had a non-banking subsidiary, their assets and liabilities would show up on the balance sheet of the parent bank, would they not?

Mr. RUBIN. On the consolidated balance sheet, that is correct.

Mr. BACHUS. So because of that, any risk or any losses that the subsidiary had would be directly attributed to the parent, would they not?

Mr. RUBIN. That is correct. But the plus side of that if the op-sub develops value, then that is an asset and enhances the balance sheet of a bank and the strength and can comprise an asset the FDIC can reach. This is asymmetrical. If on the other hand the op-sub develops problems, then it can be divested and upon the divestiture, you recognize only the actual losses. Any losses that have been consolidated into the earnings statement and therefore the net worth of the bank get reversed under generally accepted accounting principles insofar as they exceed the initial equity investment.

We are going to prepare a letter on this because of a number of members have said they thought those principles——

Mr. BACHUS. Because to me those risks and those losses would be transferred directly to the bank. I think under accounting principles.

Mr. RUBIN. Yes, but the point is, Mr. Bachus, you are raising exactly the right question which a number of other Members did, too. But if there is trouble, the bank can divest itself of the op-sub and under generally accepted accounting principles, all those problems would be reversed and you would be in precisely the same position you would have been in with an affiliate. But I think we need to get a letter to people on that.

Mr. BACHUS. We are struggling with this. I read the article by Bill Seidman, Bill Isaac and all that, so I understand. Let me go back to the unfair subsidies, whether or not there is an unfair subsidy because of access to the discount window and access to the Fedwire. I guess the other is the federally-insured deposits. Those are all benefits that banks have in our system.

Mr. RUBIN. Right.

Mr. BACHUS. I was reading something that Chairman Greenspan submitted to us in the appendix. He quoted William Brady in the Senate. Let me just read you what it said. This is a 1988 report by the Senate. It says the Senate-passed version of the financial services modernization endorses the concept that holding companies were a much sounder alternative to operating subsidiaries.

It said that academic observers and the Secretary of the Treasury firmly support this approach since it was, and I quote: "the only acceptable means of expanding non-bank activities." I will supply you with a copy of that.

Mr. RUBIN. Would you like me to respond?

Mr. BACHUS. Let me ask you this, and I do want you to respond. I then went back and I found that in 1984, and in 1983, the Treasury had submitted about a three-page testimony to the Congress. Mr. Bentsen was talking about that we get different testimony up here. We hear one thing and then we hear another. I have got about six pages here from the Treasury Department telling us in no uncertain terms that to allow affiliates to engage in non-banking activities would constitute a direct subsidy, and they go into quite a lot of detail. This is 1983 and 1984, telling us that it would be an unfair advantage. I am going to submit these for the record. But in 1988, I would admit, there is not a lot—it just makes a comment. But in 1983 and 1984, Treasury submitted—there are about three pages here that I would like you to just maybe look at. Because you did say that it is not clear whether there is a subsidy.

Mr. RUBIN. No, what I said, Mr. Bachus, was that it is not clear there is a subsidy to the bank. But it is, in my judgment absolutely 100 percent clear that under the LaFalce bill—if there is a subsidy—the op-sub has zero advantage over the affiliate with respect to the bank transferring the subsidy. The difference between 1988 and 1984 and 1983 is that under the LaFalce bill, you have a set of provisions governing both the bank's equity investment in the subsidiary, absolutely identical terms, and loans by the bank to the subsidiary, which have to be done pursuant to Section 23(a) of the Federal Reserve Act, absolutely identical. With respect to these provisions, then there is no difference. Those comments from 1988,

1984, 1983, were not written about these provisions—these rather stringent provisions, I might add—of the LaFalce bill.

Mr. BACHUS. Were you familiar with those 1983 and 1984 testimonies?

Mr. RUBIN. I was not, but as I say, Mr. Bachus, I think that though interesting, they are not relevant to the LaFalce proposal. That proposal contains the provisions I just mentioned, which create equivalent safeguards.

Mr. BACHUS. What I would like you to do, I would like to introduce them and let y'all review those and get back and make some responses why they are not relevant today.

Mr. RUBIN. We would be delighted.

Mr. BACHUS. And why the LaFalce legislation addresses that.

Mr. RUBIN. We would be delighted. Thank you.

Mr. BACHUS. Thank you. I would offer at this time the testimony of the Treasury on January 16, 1984 before the Congress; testimony of July 18, 1983; testimony of Donald Regan before the Banking Committee; and also 1988 testimony.

Chairman LEACH. Without objection, those will be inserted into the record.

[The information can be found on page 625 in the appendix.]

Ms. Lee.

Ms. LEE. Thank you, Mr. Chairman.

Mr. Secretary, Ralph Nader has expressed what other consumer advocates have also emphasized when he said, and I quote: "H.R. 10 is not a bill for consumers. It is a bill designed to create new profit centers for a relative handful of banking and financial services, corporations that will form combinations which will dominate the delivery of financial products and fuel the already alarming trend toward megamergers and the concentration of economic power."

First, let me just thank you for your strong support for CRA. As you acknowledged, it has been really a primary mechanism for access to capital in low- and moderate-income communities. I know and I appreciate your supporting those provisions with the LaFalce bill. But there are further considerations that are important to consumers. I would just like your thoughts on four ideas that might address the gap between what financial services would like to see and what consumers need. First, requiring CRA provisions to be extended to other financial services industries, maintaining the extensions of CRA provisions as incorporated in the LaFalce bill. Second, insurance companies wishing to affiliate with a bank holding company be in compliance with the Fair Housing Act, including any consent decrees entered into by that insurance company under the act. Third, insurance companies which offer homeowners insurance policies, those companies that really wish to affiliate with a bank holding company, that they have a satisfactory record in meeting the homeowners insurance needs of the entire community, including low- and moderate-income neighborhoods in which it does business. And, finally, securities firms wishing to affiliate with a bank holding company, that they not have a past pattern of excluding securities branch sales offices from low- and moderate-income communities.

Mr. RUBIN. Let me make a generic comment which I think may be useful in terms of all this. We, as you know, are extremely strong supporters of CRA. We have said that not only are we opposed to weakening CRA, we think CRA needs to be kept relevant as the world changes. That was why we think it is very important that if a bank wants to get into non-banking financial activities that they not only need a satisfactory CRA record at the time they do it, but they need to maintain it. I think you get into a problem when you get out beyond the banking system because CRA was, after all, originally envisioned as having a nexus to the various services that the Federal Government provided, particularly deposit insurance, but probably also the discount window and the Fedwire.

In all of these areas, you don't have that Federal provision of service that you do to the banks, and the theory, at least as I understand it, was that if you are going to get access to this important set of services from the Federal Government, then it is appropriate for you to take on the responsibility, which I happen to think is a very important responsibility, of complying with CRA. You don't have that in these kinds of situations.

Ms. LEE. But now because of the fact that possibly these financial services will be provided——

Mr. RUBIN. It will be provided by an op-sub or an affiliate that is either a sub or an affiliate of a bank, but they will not themselves have access to any of these Federal services. You asked me one particularly that I have never really thought about, but that is the one in respect to the Fair Housing Act. I think—let me ask Rick Carnell to comment. I believe we have actually said in the past that there may be some—that is something that is worth considering.

Rick.

Mr. CARNELL. Mr. Kennedy had an amendment to that effect that this committee adopted in 1997, and we have made statements saying that we saw merit in that approach or certainly in that objective.

Mr. RUBIN. Let me also say that since these are all ideas that themselves are complicated and one would need to analyze, we really ought to take a look at that further with you and then see. As Rick just said with respect to Mr. Kennedy's legislation, we had expressed ourselves in the way we did. Why don't we take a look at this with you.

Ms. LEE. Thank you very much. I would appreciate that because I think consumers have some really serious concerns that hopefully can be addressed as we move forward because we certainly want to support these efforts. Thank you very much.

Chairman LEACH. Thank you, Ms. Lee, and for ending before the red light came on.

Mr. Royce.

Mr. ROYCE. Thank you, Mr. Chairman.

There have been, Mr. Secretary, some efforts to develop language that would provide holding companies with some flexibility in their activities by permitting a holding company to engage in activities that are complementary to financial activities. Do you have a view on such a proposal?

Mr. RUBIN. Are you talking about complementary, but beyond non-bank financial activities?

Mr. ROYCE. They are in essence commerce, but let us say you had a credit card company that had a concierge service. There are so many situations where there is some ancillary activity that in a way is tied to the line of business, but is in fact not financial. But if you developed a definition of complementary, you might be able to handle this type of activity. I just wanted your thoughts on that.

Mr. RUBIN. Let me react in two ways if I may. Number one, I agree with what I think is the predicate of your question, which is it is sometimes very difficult to know exactly what is what in the complicated world that we are in. That is going to become more so as we go forward. Having said that, I do think if you look at what has happened over the last couple of years, it is hard not to have a lot of reservations about a combination of a depository institution with commercial activities. I think the experience of the last two years around the world, at least to me, makes all that very troubling. So I guess where I come out is I think we should—if you have the two existing categories, non-bank financial and commerce, you are going to have to decide which is which. It sounds like—complementary, although we would have to look at it to get a better understanding of it, but it sounds like that is a way of trying to pick up some of these sort of hybrid sort of things. I guess I would be a little bit troubled by it in the sense that it sounds like it is going to bring more under the tent that looks like commerce and that would sort of trouble me. But I guess we would need to look at it.

Mr. ROYCE. So I guess the answer from your standpoint would be you would be open to looking at fashioning some type of definition that would take care of existing hybrids or that would——

Mr. RUBIN. No, no, no. If I said that, I misspoke. I apologize. No, I think I would be inclined to be skeptical.

Mr. ROYCE. OK.

Mr. RUBIN. But certainly we would be happy to look at it and see if there is something there that is useful, but skeptical because I have a feeling that it will extend this affiliation either through op-sub or affiliate out beyond non-bank financial activities, and that is the area in which we have very serious concerns.

Mr. ROYCE. Thank you, Secretary Rubin.

Thank you, Mr. Chairman.

Chairman LEACH. Thank you, Ed.

Yes, Mr. Goode.

Mr. GOODE. Mr. Secretary, just one question. You stated in your remarks that you supported H.R. 665 because it avoided anti-competitive restrictions on bank insurance sales. Would that include the sale by banks of title insurance? I know in Virginia, banks operate some title companies. Would you anticipate under H.R. 665 they could continue to do so?

Mr. RUBIN. Mr. Carnell would be delighted to respond to that.

Mr. CARNELL. We have advocated that the bill not have discriminatory restrictions on national banks' sale of title insurance. The bill passed by the House during the last Congress contained such restrictions. We think that competition here is good for consumers.

We note that last year's bill didn't similarly restrict the authority of State banks. We see no good policy case for discriminatory restrictions that single out national banks.

Mr. GOODE. So they can?

Mr. CARNELL. Yes, sir.

Mr. GOODE. I yield back, Mr. Chairman.

Chairman LEACH. Thank you, Mr. Goode.

Mr. Ryan.

Mr. RYAN. Mr. Chairman, I would like to ask you two questions relating to Chairman Greenspan's testimony yesterday. You mentioned earlier in your testimony that it is easy for a bank to dump a subsidiary that becomes a liability. He outlined a couple of cases or some circumstances whereby the op-sub could lose its value so quickly that a holding company or the bank could not dump it in time, thereby exposing the risk. Could you address in your letter that you are proposing how you address those situations? I think he cited an example where an op-sub went down in 1987 in one day.

Mr. RUBIN. Yes, First Options, a subsidiary of Continental Illinois National Bank. I didn't read his testimony, but I know the situation.

Mr. RYAN. Right. Could you address that particular type of occasion and how does your lack of concern, and I am not being judgmental on that, but how does your lack of concern on the exposure to the taxpayer address those types of situations?

Mr. RUBIN. It is not a lack of concern about exposure to the taxpayer. I actually think, as I said in my testimony——

Mr. RYAN. I didn't mean to imply that——

Mr. RUBIN. No. But as four FDIC chairmen have said—one current, three prior—that the op-sub is actually preferable on safety and soundness and protecting the taxpayer. I think in this situation if you have that kind of a problem—whether it be in the affiliate or in the op-sub—you are going to have reputational issues you are going to have to deal with, and that is going to be the same either way. If you have that problem with an op-sub, you immediately sever the link, and then you have the kinds of consequences I mentioned before—putting the op-sub and the affiliate in exactly the same position. But let us address that in the letter if we may.

Mr. RYAN. You think the affiliate and the op-sub would have the same kind of situation should that type of occasion arise?

Mr. RUBIN. I think you would be in an identical situation, that is correct.

Mr. RYAN. One other quick point. Chairman Greenspan advocated a two-stage process, one where we have integration and we wait and see how that works before taking a look at commercial baskets. You mentioned that you didn't like the provision, I believe, in the LaFalce bill on the 15 percent commercial basket. Do you have the same position or are you open to Chairman Greenspan's position of waiting and seeing, having a two-stage process?

Mr. RUBIN. Well, one never wants to say that one might not change one's mind in the future, because that isn't a very sensible place to be. But I must say, based on everything I know, it seems to me the last two years have increased concerns about this linkage

rather than lessened these concerns. That is really all I can tell you, Mr. Ryan.

Mr. RYAN. Just trying to find areas where you guys agree.

Mr. RUBIN. I see. My instinct is to have very serious concerns right now. I can't tell you what a future Congress, a future administration and a future Fed chairman might feel five or ten years from now based on that experience.

Mr. RYAN. Thank you.

Thank you, Mr. Chairman.

Chairman LEACH. Thank you, Mr. Ryan.

Mr. Sherman.

Mr. RUBIN. Actually with any luck we would have the same Fed chairman. It just occurred to me, given the way the terms run.

Chairman LEACH. Excuse me. You mean in the year 2020?

Mr. RUBIN. No, I said five or ten years from now. Understanding how long the term was and when the reappointment comes up.

Mr. SHERMAN. Mr. Secretary, I think you have talked about the reputational risk that a financial institution, particularly a bank, runs when one of its affiliates or subsidiaries has financial problems and wonder whether if in your experience it matters whether that is an affiliate or whether it is an operating subsidiary, or does the institution run the same risk either way?

Mr. RUBIN. I think, Mr. Sherman, you would have the same risk in either way. I actually lived through this in my prior life. When you have these kinds of concerns and the markets get nervous, they can react to all kinds of things, real and unreal. I think we just simply have to do what we did. We called our creditors, we said this is our situation, this is where we are, this is our relation with this, that and the next thing to our basic business. Then you work it through with your creditors. In that case since the op-sub and the affiliate are in the exact same position, I don't think it is going to make a difference.

Mr. SHERMAN. Is there a greater risk that there would be a piercing of the corporate veil so that the bank parents would be held liable for the debts of one of its subsidiaries with a greater possibility of risk than if it was an affiliate?

Mr. RUBIN. As you know, piercing the corporate veil very, very rarely is held in court and for good reason, because the corporate separateness is really pretty central to how our system works. But the fact is that in order to maintain that separateness, you have to observe certain formalities. That would be also true with respect to the difference between the affiliate and the bank. And if you don't observe those formalities, I think that is right. If you inappropriately behave with respect to the affiliate and the bank, you also run the risk of the two getting mushed together.

I think the answer is that that is probably at most a de minimis risk; and the risk would exist in both the subsidiary and the affiliate, I think.

Mr. SHERMAN. I am most concerned about not where there is functional integration inappropriately of two corporations or where one corporation is, in effect, generating profits for the other, but rather the more human situation that I have seen often with subsidiaries, particularly in small- and medium-sized businesses, where the corporate minutes are prepared contemporaneous not

with the directors meeting, but with the request for corporate minutes by some investigator. And that if you had a subsidiary that simply ignored all the corporate formalities, didn't bother to have board of directors meetings, if it was an affiliate, wouldn't that cause the bank to be a bit safer than if it was a subsidiary?

Mr. RUBIN. Based on my own experience with affiliates, and we actually—when I was in the private sector we operated with a lot of affiliates. We at least were advised that there were formalities, and we had to adhere to them. If we didn't, we ran a real risk of the two being pulled together if creditors ever came against us.

I suspect there isn't a great deal of difference, Mr. Sherman. I am not opining as a lawyer on that.

It also strikes me that you are going to have bank examiners that are going to be looking at these formalities and making sure they are adhered to. I think you are talking about a de minimis risk and, if it should occur, not very much difference between the two.

Mr. SHERMAN. I would think that with bank examinations coming in, that sector of the economy may be observing corporate formalities to a greater extent than other smaller——

Mr. RUBIN. Rick, correct me if I am wrong, but I don't think there has really been a problem in the American financial—there have been a lot of problems in the American financial system, but one I don't think you have had——

Mr. CARNELL. That is correct. There are thousands of subsidiaries and affiliates of federally-insured depository institutions now, and failure to observe corporate separateness has not been a significant issue in either case.

Mr. RUBIN. Maybe because of the reason you have said, because of the role of examiners. I don't know.

Mr. SHERMAN. And also, given your experience on Wall Street, did you feel your banking competitors had a large competitive advantage or subsidy advantage when they were operating in competition with you in the securities world?

Mr. RUBIN. I am trying to think of a diplomatic way to respond. No.

Mr. SHERMAN. I have run out of questions.

Thank you, Mr. Chairman.

Chairman LEACH. Thank you.

Mr. Ose.

Mr. OSE. Thank you, Mr. Chairman.

Mr. Secretary, thank you for coming. As I did with the Chairman of the Fed yesterday, when I passed my compliments, I want to convey that you are a remarkable steward of the affairs of this country as Secretary of the Treasury. I want to convey that to you.

Mr. RUBIN. Thank you.

Mr. OSE. My question is based more on some confusion that I have. I have heard you remark as to an apparent tradeoff between for-depository institutions between access to various services that the Fed provides and taking on the responsibility of various things that Congress or the Administration may wish to have addressed, one of which, for instance, might be the Community Reinvestment Act. It would seem to me that implicit in that comment is a sugges-

tion that there is a value, on one hand, to access these services and that the compensatory nature—is that you need to help us on this.

One thing I am struggling with is trying to quantify the subsidy that comes through directly to the financial institutions by access to these services. That is my first question.

My second question has to do with the regulatory scope that would come to, in yours or Mr. Greenspan's relative positions, either the operating subsidiaries or the affiliates in terms of expanding the reach into the subsidiary or the affiliate for compliance with the Community Reinvestment Act or the like. I just think that leads to an inefficient allocation of capital, and I am concerned about that.

Mr. RUBIN. I think they are two good questions. Let me try to respond to both if I may.

It is at the very least very hard and I think probably not possible—but at the very least very hard—to, in even a rough kind of a way, quantify the subsidy. The problem was indicated by one of the other Member's questions, which is that you could certainly look at a bank versus a finance company that had the same rating, look at the difference in their cost of capital in the capital markets and say that is the subsidy.

The trouble is that the finance company is in a very different and in some ways riskier business than the bank. I don't think it lends itself to comparison. I think it is very hard. There are sensible people who think there is no subsidy. There are probably more sensible people who think there is a subsidy. Maybe there is an analysis, but I have never seen an analysis persuasive as to its amount.

Mr. OSE. Are you saying they are more sensible numerically or more sensible in terms of their sense?

Mr. RUBIN. I am not sure of the answer to that.

On the question of reaching into, we are not suggesting that CRA reaches into the subsidiary and applies to the activities in the subsidiary. That is not what we are saying. All we are saying is that if the bank has larger assets, then in some fashion that may affect how it is viewed with respect to satisfactory CRA compliance.

But let me be clear, because I think you have raised a good point. We are not saying that CRA would apply to the activities in the subsidiary.

Mr. OSE. Thank you.

Thank you, Mr. Chairman.

Chairman LEACH. Thank you.

Mr. Inslee.

Mr. INSLEE. Thank you, Mr. Chairman.

Mr. Secretary, I noticed that you expressed a caveat regarding H.R. 665 because you said you had serious concerns about the affiliation between commercial firms and depository institutions which this bill would permit. I just wondered if you would tell us what changes, either small or large in this bill, would at least reduce, if possible, those concerns.

Mr. RUBIN. H.R. 665?

Mr. INSLEE. Yes.

Mr. RUBIN. Let me start by saying it is a very good bill. I was a little bit surprised, but very pleased that we are in a position to support a bill at this point because I think that is a very construc-

tive development in terms of moving forward with financial modernization legislation. The set of concerns that I caveated had to do with, as I said, depository institutions and commercial activity; and there were two subsets of that, I suppose, the basket and then the unitary thrift.

We think, with respect to the unitary thrift, that H.R. 10's resolution last year, the grandfathering resolution, was a sensible place to be.

I guess it would be fair to say that, on the basket, we just have very serious reservations, for the reasons I have stated.

Mr. INSLEE. And as far as the basket, is there a matter of quantification of percentages or the like or just its basic thrust?

Mr. RUBIN. I think it is the fundamental concept of combining the commercial with the depository institution.

Mr. INSLEE. Thank you.

Chairman LEACH. Thank you.

The gentlelady from Illinois.

Mrs. BIGGERT. Thank you, Mr. Chairman.

Mr. Secretary, H.R. 10 has a provision that would require the Office of Thrift Supervision to notice and comment upon preempting State laws regarding consumer protection, but I guess it is H.R. 665, the LaFalce bill, does not have that. Considering that the Office of the Comptroller of the Currency is subject to such a requirement, why should not the OTS also be required to operate in the sunshine?

Mr. RUBIN. Let me ask Mr. Carnell to respond to that, if I may.

Mr. CARNELL. We haven't previously taken a bottom line position on this proposal. I note that the requirement applicable to the OCC arose in the context of interstate banking legislation.

I also note that the thrift charter has had much more of a history of an exclusive, comprehensive system of Federal regulation than in the banking area. That is, the courts have often found that rules of the OTS or its predecessor occupied the field and preempted State law.

It is partly for this reason that many observers see the thrift charter as particularly desirable for use in facilitating electronic commerce—such as when people use the internet to do transactions in which the parties' geographical location is not especially meaningful. That is a significant advantage people perceive in the thrift charter. And there is also a legal distinction of sorts. Over the years, the courts have found that thrifts are under a much more comprehensive and embracing system—and one that relies less on State law—than is the case with national banks when they deal with their customers.

Mrs. BIGGERT. Thank you.

Then, somewhat similar, there doesn't seem to be any concern about the safety and soundness of the WFIs and that WFIs are not allowed to have deposit insurance, yet they are subject to regulatory supervision from the appropriate Federal regulator. Do you have concerns about that?

Mr. RUBIN. We were originally in favor of WFIs, but I think it would be fair to say that, as we have again looked at the experience of the last couple of years around the world and all that has happened in financial markets, that we now have developed con-

cerns about having financial institutions with access to a fair portion of the safety net—although not deposit insurance—that would be subject to or certainly have the potential of being subject to a substantially lesser degree of regulation.

Mrs. BIGGERT. Thank you very much.

Thank you, Mr. Chairman.

Chairman LEACH. Thank you, Ms. Biggert.

The other gentlelady from Illinois, Ms. Schakowsky.

Ms. SCHAKOWSKY. Thank you, Mr. Chairman.

Let me just say to you that, as one who has never participated in this debate at all, I want to thank you for these hearings which have been a seminar without compare for someone in a position as mine.

Mr. Secretary, let me ask you a couple of questions. I am a little confused about—you see Mr. LaFalce's bill as an advantage for CRA because the consolidated assets of the bank will be greater as a result of the op-sub. By that do you see that, should a bank increase its assets by half again, let's say, that then their CRA obligation is increased by that amount in terms of dollars that would be made available to the community?

Mr. RUBIN. No, not necessarily. I think there were two respects in which I believe this to be the case. One is that the LaFalce bill requires that for you to get the new financial affiliations, you must have a satisfactory CRA record, and you must maintain it. That, I think, is a very important requirement. I think the point was not that there was some sort of numerical formula, but rather that, all other things being equal, if the bank has larger assets because it has kept these activities in the op-sub rather than smaller assets because they have done it in the affiliate, that as bank examiners look at a satisfactory CRA record they are likely to expect something more robust.

Ms. SCHAKOWSKY. So you don't see any—and perhaps this is best directed to Mr. LaFalce—but you don't see there necessarily being an increase in the amount of dollars that are available?

Mr. RUBIN. Not necessarily, but it would seem to me that, while not necessarily an increase in the dollars in each instance, on balance there would be a more robust CRA if the assets were in the bank than if they are outside the bank.

Ms. SCHAKOWSKY. Let me ask another question that gets to the issue. It seems to me one of the ways to evaluate both pieces of legislation in the final outcome is a way that there are expanded opportunities for consumers and communities and not just financial institutions. So let me ask you what your view is on low-cost banking, lifeline banking and whether or not that ought to be a component of the final legislation.

Mr. RUBIN. Yes, I think this is all about consumers. In fact, one of the arguments we have made is that, if there is no reason not to allow a choice of forum, you should allow the choice because that would, in the final analysis, be better for consumers.

In terms of lifeline banking, we have in the past said that we very much share the objective of lifeline banking. As you may know, the Treasury has now—I don't know if we have put this out yet or not actually. I think we have put out——

Ms. SCHAKOWSKY. Are you making an announcement?

Mr. RUBIN. No, I am not. I think this is actually public long since. Electronic funds transfer requires an ETA account, which really has exactly the same objective, to bring the least well-off in our society into the banking system. It is the same objective as lifeline banking.

In terms of the particulars of lifeline banking, I think we would need to look at a proposal with you—or Ms. Waters, who, I know, is very interested in this—and see exactly what the specifics are; but it is an objective that we have supported and are actually pursuing in this other context.

Ms. SCHAKOWSKY. Do you think its inclusion in this legislation would enhance it from the standpoint of——

Mr. RUBIN. It depends on what the provision read like. As I say, I think the objective is a sound one. Whether it should be in this legislation or not I think would depend largely on what the provision actually was.

Ms. SCHAKOWSKY. But, in concept, would you support its inclusion in this legislation?

Mr. RUBIN. I think that in concept I would support what we would support and not support what we would not support.

It strikes me that that may not be totally helpful. I have spent too much time with Chairman Greenspan.

What I meant was that we support the objective. A particular provision I can't judge in the abstract. We would have to look at it.

Ms. SCHAKOWSKY. Thank you very much.

Thank you, Mr. Chairman.

Chairman LEACH. Thank you.

Mr. Capuano.

Mr. CAPUANO. Mr. Chairman, I have no questions. I intend to forgo the opportunity to make a speech until a later time.

Chairman LEACH. Does anyone else want anything briefly in terms of a second round?

Mr. Bentsen.

Mr. BENTSEN. Mr. Secretary, I know you are going to follow up with a letter on this, going back to this question of the subsidiary and how it applies under general accounting procedures. But, in effect, when you are looking at the balance sheet with an operating subsidiary versus a holding company structure, the subsidiary is treated as an asset and you look at both the assets and liabilities, but is it treated like a nonrecourse investment, where it upstreams the benefit? But in the event that there is a loss there is no obligation to the parent to the subsidiary and, thus, that is what is reversed on the balance sheet?

And, second of all, from the perception of the markets, capital markets, in this instance, on the idea of the subsidy, would it not be the case that when you looked at the balance sheet of the bank as the parent, you would also value the subsidiary?

So while on the one hand you might value the subsidiary to the good of the bank when it is doing well, you would also value the subsidiary to the bad of the bank when it was doing bad. That I say from the standpoint of the subsidy issue. But from the safety and soundness issue, it is a nonrecourse investment.

Mr. RUBIN. Yes. And I would add, Mr. Bentsen, that if the subsidiary was doing badly, just as if the affiliate was doing badly—and I actually lived through this in my old life and that started to create some kind of difficulties with creditors—I think you have to bring your creditors in and explain precisely what your position is. The answer is precisely what you just said. The bank's investment in the op-sub is nonrecourse. So I think in either case you are going to have to go through your position with your creditor. When you do, I don't think your position is one iota different whether you have a subsidiary or an affiliate.

Mr. BENTSEN. With the Chairman's indulgence, then, when you are looking at the holding company, I guess what you are saying is whether you are looking at a national bank with a subsidiary or looking at a holding company with an affiliate, in either case, if one is doing bad, it will reflect poorly on the parent, either whether it is a holding company or a parent with a subsidiary.

Mr. RUBIN. The reputational reflection is in either case and the financial reality, for the reasons you have said and I also commented on before, will be exactly the same; and you have to deal with both of them.

Mr. BENTSEN. Thank you.

Thank you, Mr. Chairman.

Chairman LEACH. Thank you.

Mr. LAFALCE. Mr. Chairman, I am kind of anxious to get to the second panel, but I just want to have a brief question, first, of Mr. Carnell.

Mr. Carnell, some individuals refer to the unitary thrift charter as a loophole. That usually conjures up the images of some inappropriate interpretation of a word that is vague and ambiguous. With respect to the unitary thrift charter, is it not correct that there are specific statutory provisions that call for this and outline what specifically may be done? Is that correct?

Mr. CARNELL. Yes, it is, Mr. LaFalce.

Mr. LAFALCE. So it is not a loophole. It is something that has been statutorily prescribed for several decades and specifically prescribed, is that correct?

Mr. CARNELL. Yes. Congress adopted the statute in the late 1960's.

Mr. LAFALCE. OK, good, thanks.

Secretary Rubin, since the late 1960's when the Office of Thrift Supervision and its predecessor regulators have been implementing this congressional intent, are you aware of any difficulties of significance that have been caused by the unitary thrift holding companies?

Mr. RUBIN. As I said before, Mr. LaFalce, my concern——

Mr. LAFALCE. My question is the historical experience from the late 1960's.

Mr. RUBIN. My concern derives really from the experience we have had around the world the last couple of years in its more general sense.

Mr. LAFALCE. I am talking about the unitary thrift holding companies.

Mr. RUBIN. I understand. As to the specific question, do I personally know of problems in the unitary thrifts because of this combination, the answer is that I do not have such personal knowledge.

Mr. LAFALCE. Thank you.

Chairman LEACH. Mrs. Roukema.

Mrs. ROUKEMA. Mr. Chairman, I am not going to ask for any time in terms of an answer, but as a follow-up. I had hesitated asking for this written documentation until I heard Mr. Bentsen's question. Then I felt maybe it is appropriate, and I would like to submit it for both you and the Fed because you have very different views here, but it is central to the question of the operating subsidiaries.

Would you please give me, because Treasury and the Fed have very different perspectives here, but it is a good case example, an object lesson it would seem for our records. That is a chronology of the Continental Illinois/First Options case? This is the operating subsidiary/holding company question. You take a very different point of view from the Fed, as I understand it, as to what occurred. I will submit a request to the Fed as well. If you could please get it to us for the record and for my personal consideration.

Mr. RUBIN. We will get both the chronology, and we will also get an analysis of how that would work under the structure that Mr. LaFalce suggested.

[The information referred to can be found on page 661 in the appendix.]

Mrs. ROUKEMA. Excellent. Very good. Thank you.

Mr. RUBIN. Could I make one comment, Mr. Chairman? Because it didn't come up, and I was hoping it would or I thought it would.

Chairman LEACH. Mr. Secretary.

Mr. RUBIN. There is one respect, and I think the Chairman is aware of this, that we have changed our position with respect to the op-sub from last year to this year. That is, that while I have no doubt, zero doubt in my mind, as to the identity of the situation with respect to both subsidy and safety and soundness, we also recognize that, for all kinds of other reasons, there are a lot of reservations that many Members have about having insurance underwriting in the op-sub.

In our judgment I have to say we have always felt that the essential nexus here is between commercial banking on the one hand and investment banking, underwriting, trading on the other. And that latter set of activities, to the best of my knowledge, virtually always involves merchant banking, which is why we think merchant banking needs to be integral to that. It is that nexus of activities that it seems to us is at the heart of this.

While I think there is zero substantive reason for excluding insurance from the op-sub, we are prepared to accept that exclusion if that would contribute to getting financial modernization legislation even though we think there is zero substantive reason for doing it.

Chairman LEACH. I appreciate that. That has been duly noted.

I want to raise just a couple of observations on issues that have been raised here. One relates to an earlier discussion on the Federal Home Loan Bank System and GSEs in general and arbitrage. This committee, like the Treasury, is deeply concerned that pri-

vately, in effect, owned institutions are reaping public advantage in the marketplace which tilts the marketplace rather dramatically. At issue is not only the arbitrage in the Federal Home Loan Banks, which I believe is too large, but small institutions like Farmer Mac, which in percentage terms I think represents a virtual scandal in the country in their arbitrage activities.

When Congress creates institutions for a public purpose that have advantages in the marketplace exactly as you have represented, they should stick to their public purpose. I would be hopeful that both formally and informally the Congress and the Executive Branch can attempt to change this direction.

Second, Congressman Vento raised an issue that relates to current law in the question of whether a 10 percent cap should be changed with regard to concentration. I will say as strongly as I can I cannot think of a greater nonstarter issue. There is no prospect that I know of that this committee would endorse raising the cap and allowing a greater concentration.

Finally, let me say that when Chairman Greenspan testified before us yesterday, the market went up. I am sorry to say it is down a little bit today. We may be asking for his return.

Mr. RUBIN. I believe markets have a tendency to be somewhat random in many respects, Mr. Chairman.

Chairman LEACH. I am sure it doesn't relate to anything that may have been murmured at this hearing.

The upshot and just by perspective is that I think the consensus is widening and deepening that financial modernization should occur in the near future. We are struggling to come up with the last remaining truly significant compromise which involves the Executive Branch. If the Executive Branch does not want to advise us, that is, the Executive Branch in concert with the Federal Reserve, we may have to work it out ourselves, which is the difficulty of legislators.

I would reemphasize that I have found in my tenure in this Congress that it is always wise to be as deferential as possible to the professional judgment of professionals in the field. When professionals in the field are at variance, it is hard to be deferential. That is the dilemma that we have.

In any regard, we appreciate your testimony.

Secretary Carnell, we appreciate your additions. We look forward to working with you in the weeks ahead.

Mr. CARNELL. Thank you, Mr. Chairman.

Chairman LEACH. Our second panel is composed of Ms. Donna Tanoue, who is Chairman of the Federal Deposit Insurance Corporation; Mr. John D. Hawke, Jr., who is the Comptroller, Office of the Comptroller of the Currency; Ms. Ellen Seidman, Director of the Office of Thrift Supervision, and Mr. Harvey J. Goldschmid, who is the General Counsel of the Securities and Exchange Commission.

Chairman LEACH. We will proceed then with Ms. Tanoue. Thank you.

STATEMENT OF HON. DONNA TANOUE, CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION

Ms. TANOUE. Thank you.

Good morning, Mr. Chairman, Mr. LaFalce and Members of the committee. I appreciate this opportunity to present the views of the FDIC.

H.R. 10 is a very positive and significant start toward financial modernization. The FDIC, however, believes that H.R. 10 can be improved. In particular, we believe that, absent a compelling public policy purpose, the Government should not impose an organizational structure on banking organizations.

It is true that a subsidiary structure does, under certain circumstances, provide superior safety and soundness and superior protection for the deposit insurance funds. However, there can be legitimate business reasons for a banking organization to prefer an affiliate structure. Some have argued that the Government should impose a holding company structure because the safety net creates a subsidy.

As our written testimony indicates, there is some question as to whether a net marginal subsidy from the safety net exists at all. But if it does, appropriate safeguards would inhibit a bank from passing it to either a subsidiary or to a holding company affiliate. Therefore, given appropriate safeguards, banks should have the choice of conducting new activities in either holding company affiliates or bank subsidiaries.

Turning to other issues, the FDIC continues to favor a cautious easing of restrictions on the mixing of banking and commerce; and we are concerned that, in implementing a greater degree of functional regulation, the bill reduces the authority of Federal banking regulators to determine the appropriate products and services of banks.

There are three other items I want to touch on this morning—items that strike right to the core of the FDIC's mission.

First, we commend the committee for retaining the FDIC's ability to examine a bank affiliate to the extent necessary to protect the insured bank. We have used this authority sparingly in the past and only after careful analysis.

Second, we strongly support the provisions of H.R. 10 that would eliminate the SAIF Special Reserve. If the Special Reserve is not eliminated, it could lead to an assessment rate disparity between the BIF and the SAIF.

And, third, for many reasons, which we discuss in our testimony, the FDIC urges the committee to use H.R. 10 to merge the two Federal deposit insurance funds. Such a merger would eliminate a fundamental weakness in the Federal deposit insurance system.

The BIF and the SAIF are both fully capitalized with identical assessment rate schedules, and the members of both funds are healthy and profitable. Upon elimination of the SAIF Special Reserve, the reserve ratio of the SAIF would be restored to reflect its true level, and the BIF and the SAIF would have comparable reserve ratios, and a merger of the two funds would not result in a material dilution of either fund.

In conclusion, we have a unique opportunity to achieve financial modernization. This bill represents a good starting point, and the FDIC stands ready to work with you and Members of the committee in this important endeavor.

Thank you.

[The prepared statement of Hon. Donna Tanoue can be found on page 705 in the appendix.]

Chairman LEACH. Well, thank you, Ms. Tanoue; and we appreciate your testimony.

Mr. Hawke.

STATEMENT OF HON. JOHN D. HAWKE, JR., COMPTROLLER, OFFICE OF THE COMPTROLLER OF THE CURRENCY

Mr. HAWKE. Thank you, Mr. Chairman. Mr. LaFalce, Members of the committee, I appreciate the opportunity to be with you today. At this hour on a Friday, I don't want to burden the committee with a lengthy statement; and if I may, Mr. Chairman, I ask that my entire statement be placed in the record.

Chairman LEACH. Without objection. That applies to all the panelists.

Mr. HAWKE. There are complex issues in this bill, but the one that has emerged as pivotal is the major issue that divides us from the Federal Reserve. The Federal Reserve would mandate that all new financial activities of banking organizations be conducted only under their jurisdiction in holding company affiliates. We support giving institutions the freedom to choose the affiliate or subsidiary format, in either case, subject to exactly the same strong safety and soundness protections for the bank.

Let me point out the inexplicable anomalies and inconsistencies in the Fed position.

First, State banks today are free to conduct through subsidiaries any activities authorized by their States, subject only to a determination by the FDIC that the activity would present no significant risk to the insurance fund. A number of States have already authorized such activities as securities and annuities underwriting, and the FDIC has approved these activities. No explanation has been offered why national banks should be denied authority already possessed by State banks, and the Fed does not propose to bar State banks from conducting activities different from what are permitted for national banks.

Second, any U.S. bank can conduct activities abroad through subsidiaries, subject to Fed approval, and the Fed has consistently permitted securities underwriting as a permissible activity, with no apparent concern for safety and soundness threats or "subsidy" policy.

Third, foreign banks can engage in a broad range of activities in the U.S. through subsidiaries. For example, a significant percentage of the so-called Section 20 affiliates approved by the Fed are, in fact, direct subsidiaries of foreign banks.

In light of these precedents, a very heavy burden rests on those who would single out national banks for the kind of discriminatory treatment that H.R. 10 proposes, and I submit that burden has not been carried.

Let me now turn to the subsidy argument. The argument itself is unclear, to say the least; and there is sharp disagreement as to whether any net subsidy exists. But, for the sake of argument, let's assume that banks do enjoy some such subsidy. The question demanding a comprehensible answer is what difference organizational format makes. Before Congress outlaws the use of subsidi-

aries and deprives American banking organizations of the ability to use this format, it should require a compelling showing that the affiliate format is materially better in containing any subsidy than the operating subsidiary format. No such showing has been made, nor can it be made in light of the constraints that would apply.

First, the same firewalls would apply in the case of each format. The bank could not lend to a subsidiary on any more favorable basis than to an affiliate.

Second, any equity investment by the bank in a subsidiary could be no more than the bank could pay upstream to its parent holding company by way of dividends.

Third, any such equity investment would have to be deducted from the bank's regulatory capital in determining whether the bank complied with the well-capitalized standard. Thus, the effect on regulatory capital would be exactly the same as the payment of a dividend. In fact, if a subsidy exists, funds do not need to move at all within the company. The existence of a subsidy at any place in the structure benefits the consolidated organization, and the organization can allocate the benefit of that subsidy in a variety of ways to whatever element of the organization it chooses.

To illustrate, if bank earnings indeed reflect the benefit of a subsidy, the holding company can allow its securities underwriting affiliate to use that benefit by simply lowering its prices. The affiliate gets a competitive advantage, and it all washes out on the consolidated books of the holding company.

In short, given these constraints, organizational format should be reviewed as wholly irrelevant to the subsidy issue.

Real world experience demonstrates, moreover, that banking organizations have not been acting as if such a subsidy exists. Such activities as mortgage banking, commercial and consumer finance and data processing are presently conducted both through holding company affiliates and banks subsidiaries, as evidenced in the table that I would like to submit for the record.

[The information can be found on page 757 in the appendix.]

Mr. HAWKE. Let me finally turn to what I think is the most compelling argument against the Fed position, the importance of the operating subsidiary for the safety and soundness of a bank.

Chairman Greenspan was absolutely right two years ago when he testified before this committee that the op-sub does not present a safety and soundness problem. If his staff has recently persuaded him to abandon that correct position, he should not have listened to them. He should be listening to the message that has come from every FDIC chairman in recent history.

The fact is that there is not a penny's worth of difference in the exposure of the bank to the risk in new financial activities when those activities are conducted in op-subs as distinct from holding company affiliates. The protections are exactly the same. In fact, if this committee had adopted the Treasury Department's proposal in the last Congress to provide insured banks with safeguards against piercing the corporate veil, those protections would be even stronger.

The most troubling aspect of the Fed position is that, in the name of guarding against the spread of some ethereal subsidy, it would in fact compromise safety and soundness.

First, it would mandate a format that would inevitably weaken banks by forcing them to use their resources to capitalize and fund holding company affiliates rather than husbanding those resources in the bank.

Second, it would deprive banks of the opportunity to diversify their revenue flows by capturing the benefits of business opportunities generated by their day-to-day banking activities and, instead, would divert those revenue flows to the holding company where they would be unavailable to the bank.

Third, it would deprive the FDIC of the ability to cushion its losses when a bank gets into trouble by selling off profitable subsidiaries.

Anyone who had any involvement in the wave of banking failures ten years ago knows only too well how difficult it was for the banking regulators, including the Fed, to force holding companies to come to the aid of their troubled banks. Yet the Fed position today would not merely sanction the diversion of bank resources to affiliates, but it would mandate it. To me, it is simply inexplicable that an agency responsible for promoting and preserving the safety and soundness of banks would advocate a position that would have exactly the opposite effect.

Finally, let me address what I think is really at the heart of this debate. Fed witnesses have objected to the op-sub because of concerns about the evolution of a universal bank, which is a clear mischaracterization, and they have spoken about the atrophy of the holding company that would result. The notion is that if op-subs were permitted, holding companies, which the Fed regulates, would wither and die, and the Fed's window into the banking system would become less effective.

If that were a realistic threat, I could understand the Fed's concern; but I have yet to find anyone in the marketplace who thinks there is any substance to this concern. Even if op-subs were permitted, there still are a myriad of reasons for having a holding company, as any businessman will tell you.

But if anyone has any concern at all in this regard, there is a simple answer. Congress can require that any bank over a specified size—$1 billion, $5 billion, $10 billion—that wants to exercise newly authorized activities through an op-sub must continue to maintain a holding company and be regulated as such by the Fed. This will have little or no practical impact on any institution and will assure that the Fed's present role is preserved.

Mr. Chairman, I respectfully submit that anyone who advances a proposal to impose legislative restrictions on the way our financial services firms organize their businesses, particularly restrictions that grossly discriminate against national banks, is under a heavy burden to put forth a clear, consistent and broadly understandable rationale demonstrating that only through such restrictions can well-defined governmental interests be protected. Restrictions cannot be justified either to protect competitive advantages of particular segments of the industry or to alleviate fears about a loss of regulatory jurisdiction. I regret to say that I believe that burden has not been carried in this legislation.

Thank you, Mr. Chairman.

[The prepared statement of Hon. John D. Hawke Jr. can be found on page 747 in the appendix.]

Chairman LEACH. Thank you, Mr. Hawke.

Ms. Seidman.

STATEMENT OF HON. ELLEN SEIDMAN, DIRECTOR, OFFICE OF THRIFT SUPERVISION

Ms. SEIDMAN. Thank you very much.

Good afternoon, Chairman Leach and Congressman LaFalce and Members of the committee. Thank you for this opportunity to present the Office of Thrift Supervision's views on financial services modernization, H.R. 10 and H.R. 665.

In our experience, the modern thrift charter provides business flexibility coupled with sound regulatory oversight. Although it is not the only way to structure a modern charter, it is a model worth studying and certainly worth preserving as it continues to serve America's households and communities with over 70 percent of thrift assets in residential mortgages or mortgage backed securities.

The unitary thrift holding company provides a unique combination of permissible affiliations and restrictive operating conditions. Although a thrift may affiliate with any type of commercial entity, restrictions under which the thrift operates protect it from the types of concerns raised about the mixing of commercial banking and commerce.

Unitary restrictions provide that a commercial company may own only one thrift, although it may acquire additional troubled or failing thrifts which, by the way, helped commercial companies infuse at least $3 billion of capital into the industry in the late 1980's.

A statutory bar on lending to affiliates not engaged in permissible bank holding company activities prohibits—it doesn't limit, it prohibits—a thrift from making credit available to commercial affiliates. Our rules also limit the amount a thrift may dividend or distribute to a parent holding company.

Maybe most important, other than the absolute prohibition on making credit available, Federal thrifts' commercial lending is constrained. These are not commercial banks. By statute, thrifts may only hold 10 percent of assets and commercial loans, with an additional 10 percent of assets for small business loans. This limit, coupled with the qualified thrift lender requirement which generally requires thrifts to maintain a consumer lending focus, effectively constrains the ability of thrifts to engage in traditional commercial bank lending.

And statutory anti-tying restrictions prohibit a thrift from conditioning loans on the requirement that a borrower purchase other services from an affiliate of the thrift, thereby preventing indirect benefits to a commercial affiliate.

In fact, despite all of the hoopla about the unitary, commercial ownership of thrifts remains very limited. Currently, only 24 of the approximately 550 unitary holding company structures have commercial activity within them; and, in many cases, it is a very small amount of commercial activity.

The vast majority of charter applications come from groups of individuals and from insurance and securities companies, all of whom could own a commercial bank with full commercial lending powers if H.R. 10 were enacted in its current form.

I am actually reminded that one of the new applicants who raises the commercial issue is Nordstrom. So I took out my Nordstrom credit card and checked what this was all about, and it turns out that Nordstrom—this credit card is issued by Nordstrom's National Credit Bank. So I checked on what that was, and it turns out that this horrible commercial combination already exists, and, moreover, it is exempt from the Bank Holding Company Act and Sections 23(a) and 23(b), which provide restrictions that are actually good but less-strong than the restrictions under HOLA.

Another balance in the Federal thrift charter is the tie between a consumer lending focus and the ability to operate under uniform Federal standards. Unlike commercial banks, and this is Mrs. Biggert's question, Federal thrifts are statutorily required to direct most of their lending activities to consumers. In exchange, Federal law affords thrifts the opportunity to engage in these lending activities on a nationwide basis with one set of Federal laws and regulations governing their lending and deposit-taking activities.

Since September 25th of last year, three mortgage banking companies with a total of $100 million in assets and much higher originations have become thrifts, moving these assets voluntarily under CRA. We believe that one of their major incentives was the preemption. But our authority is limited. OTS rules issued after notice and full opportunity for public comment specified that even with respect to lending and deposit-taking, Federal law does not preempt State laws that further vital State interests and have incidental impact on thrift operations.

For example, we recently declined to preempt a State ATM lighting law that was clearly enacted to protect ATM users. A less obvious example involved a State law requiring lenders to correct a per loan fee from borrowers on behalf of the State. Because the State law involved a relatively minor burden applied to all lenders and had an incidental impact on thrift operations, we concluded it was not preempted by Federal law.

The Federal thrift charter also has a unique combination of consolidated regulatory oversight and functional regulation. On the one hand, OTS is the consolidated Federal regulator for all Federal thrifts, their subsidiaries and their holding companies, except where the holding company also owns a bank. This approach has worked well. We have accessed information on the institution's operations and the institution has consolidated regulatory oversight that has focused on the safe, sound and compliant operations of the thrift.

But simultaneously, and I think this is extremely important, thrifts also operate under functional regulation with its securities and insurance activities permissible almost exclusively in subsidiary service companies or affiliated holding company parents or subsidiaries which are functionally regulated by the in State regulators, the SEC and the appropriate self-regulatory organization. Primarily, oversight of the respective activities remains with the

functional regulator with whom we work closely when an issue affecting the thrift or its customers arises.

The thrift charter has allowed local, community-based organizations to offer a full range of financial products and services to consumers; and the charter encourages innovation in the design and delivery of financial systems and products, with new entrants providing more choices for consumers and new delivery systems for previously hard-to-reach markets.

We, therefore, oppose the provisions of H.R. 10 that would restrict the unitary thrift holding company or that would impose conditions on uniform Federal standards for thrifts.

We are pleased that H.R. 10 includes a provision to eliminate the SAIF Special Reserve and to return more than a billion dollars in the reserve to the SAIF. Eliminating the reserve will preserve the capital cushion of the SAIF to absorb insurance losses and to avoid the possibility of an artificial, but harmful, premium differential, the fear of which could reinvigorate that most pointless of all financial transactions, deposit shifting.

And we continue to support a merger of the Federal deposit insurance funds. The economic and managerial inefficiencies of a two-fund structure where many institutions hold deposits insured by both funds should be eliminated.

Before concluding, I want to comment briefly on H.R. 665. It has many attractive features by focusing only on the key elements necessary for financial modernization and avoiding some of the pitfalls of other approaches. And in particular, of course, we are pleased that H.R. 665 leaves the unitary thrift holding company structure in place, allowing institutions to decide whether that structure or some other best suits their business goals and needs.

Mr. Chairman, despite our serious concerns regarding some of the provisions of H.R. 10, I do want to emphasize that we support financial services modernization and agree with your goals for such legislation. Based on our experience, both the thrift charter and the unitary thrift holding company structure meets these goals. Similarly, we support retaining existing Federal law that facilitates the implementation of the mandate under which Federal thrifts operate under uniform national standards based on the best practices found throughout the country.

And, finally, we urge the committee to take the opportunity presented in H.R. 10 to merge the two Federal deposit insurance funds and to eliminate the SAIF Special Reserve.

I look forward to working with you during the 106th Congress toward enactment of financial services modernization that achieves these goals.

Thank you.

[The prepared statement of Hon. Ellen Seidman can be found on page 825 in the appendix.]

Chairman LEACH. Thank you, Ms. Seidman.

Mr. Goldschmid.

STATEMENT OF HARVEY J. GOLDSCHMID, GENERAL COUNSEL, U.S. SECURITIES AND EXCHANGE COMMISSION

Mr. GOLDSCHMID. Chairman Leach, Representative LaFalce, Members of the committee, on behalf of the Securities and Ex-

change Commission, I would like to express the Commission's appreciation for the opportunity to testify today. I know Chairman Levitt deeply regrets he couldn't be here.

The Commission joins a consensus that Chairman Leach mentioned at the beginning of the hearing, strongly supporting financial modernization. It believes now is the time to act.

This year Congress has an extraordinary opportunity to craft a legal framework and adapt to the dynamic change the financial services industry is undergoing. America's capital markets today are the envy of the world; and, in the process, we have moved from a Nation of savers to a Nation of investors.

American families today put more of their savings in mutual funds than in insured bank accounts. And it is, therefore, critical—a word I must underscore—to insure that we have a framework that maintains the strength, the discipline, and the vitality of our securities markets. Such a framework must allow the Commission, as the Nation's primary securities regulator, to continue to fulfill its mission to protect investors and safeguard the integrity of markets.

The version of H.R. 10 passed by the House in May of 1998, while not perfect from the Commission's perspective, did recognize the fundamental differences between banking and securities activities. As a result, the Commission expressed its support. Since that time, however, the basic principle that the Commission would retain supervisory and regulatory authority over the U.S. securities markets has been diluted and complicated.

Regrettably, Mr. Chairman, the Commission cannot support the version of H.R. 10 now before the committee. The bill as it stands creates too many loopholes, and that is a serious word in this context. Too many products are excluded. Too many activities are exempt from securities regulation. We fear the scope of these loopholes, which are ambiguously drafted, may create even greater problems and uncertainties in the future.

The bill, for example, would create the following problem: Two investors receive recommendations to buy the exact same security, one in a bank, one in a brokerage firm. However, because the bill clouds the distinction between banking and securities activities, these two investors may receive very, very different kinds of protection. In contrast to where securities laws are applicable, the bank investor may not be able to make claims against a bank for unsuitable investments.

Furthermore, he or she would not be protected by the SEC's failure to supervise doctrines, by securities licensing procedures, by securities arbitration remedies and, perhaps most importantly, by the Commission's extremely effective enforcement program. The bank investor in most cases would not even know that he or she had given up these protections.

At best, the state of affairs is inconsistent. At worst, which may very well be the case, it is dangerous.

There are more investors in our markets today than ever before. Every day they choose from an increasingly wider array of products and providers, but they should not have to give up basic safeguards in the process.

And the same is true about the SEC's capital requirements. They provide greater protection for market exposure and volatility than the capital requirements imposed by bank regulators which focus on credit exposure.

The purpose of my testimony today is not to comment on each specific provision of H.R. 10. Instead, I would like to outline the broader points the Commission feels must be addressed by any successful financial modernization bill.

As I indicated earlier, it is critical the Commission retain supervisory and regulatory authority over our securities markets, regardless of where a security is bought or sold. In addition, we must be able to continue to determine how securities are defined.

The following five key safeguards are needed in financial modernization legislation: Provisions assuring effective, aggressive SEC policing and oversight authority over all securities activities; provisions safeguarding customer interests and market efficiency by recognizing the SEC's right to set net capital rules for all securities businesses; provisions ensuring investors will be able to count on protection through SEC enforcement of sales practices rules for all securities; provisions protecting mutual fund investors through uniform advisory regulations and conflict-of-interest rules; and, finally, provisions allowing for the maintenance of America's global competitiveness through the establishment of voluntary broker-dealer holding companies.

In conclusion, these five key objectives are not novel; nor are they secondary. They have been the central themes of the Commission's testimony to date. We urge the committee to work toward a regulatory framework that fits today's marketplace without compromising the Nation's historic commitment to investor protection in preserving market integrity.

Again, thank you for the time.

[The prepared statement of Harvey J. Goldschmid can be found on page 853 in the appendix.]

Chairman LEACH. Well, thank you very much, Mr. Goldschmid.

First, let me just say we will take your views into consideration. We have a great deal of respect for the SEC. But I think it has to be emphasized that all of the regulatory bodies have testified that they want maximum authority within their regulatory body. And that doesn't mean that there isn't regulation that doesn't exist through another regulatory body, whether it be at the State or Federal level; and so sometimes the testimony we receive, in the view of the Chairman, it is a bit overstated.

Having said that, let me just ask you, if you take the framework today of a securities sales in a bank versus the framework of H.R. 10, isn't H.R. 10 a better framework than today's current law with regard to banking securities activities?

Mr. GOLDSCHMID. Well, Chairman Leach, let me start by saying, there is nothing territorial in this. In my case, as you may know, I am an academic. I spent most of my life at Columbia. The SEC's concerns are about one of our great industries that has been one of our most successful. The securities business works, it is a national treasure. If you take away the effective enforcement that you have had from the SEC, it is not about territory, it is about the future of a key industry, a diamond in our financial structure.

Now, in terms of the way things work now, banks are going to be expanding out under either of the bills that have been proposed here. The problem now is real. We have been enormously concerned.

My written testimony suggests, for instance, we now can't reach investment advisers. When Glass-Steagall was written and then the 1940 act was written, the assumption was banks would not have mutual funds and would not have investment advisers. We can currently reach mutual funds, but not the advisers.

We have had very serious problems with banks in which the advisory functions have not worked well, and we haven't been able to reach supervisors or problems or get information or use our compliance system. If you continue and expand these activities, we are asking, in my not-so-gentle and not-understated view, for potential national tragedy. The securities laws work. We must not interfere with how well they are working now.

Chairman LEACH. Thank you.

Mr. LaFalce.

Mr. LAFALCE. Mr. Hawke, you gave a very, very strong statement with respect to the desirability, if not, indeed, the necessity of choice with respect to an operating subsidiary as opposed to an affiliate, and different strong words with statements made by the Federal Reserve Board. You at one time were associated with the Federal Reserve Board, were you not, and you had a rather prominent position. What was that position you had with them, when, for how long, and so forth?

Mr. HAWKE. Mr. LaFalce, I am reminded of a statement that my late partner, Thurman Arnold, used to make as he got up into the elder stages of life. He said, "I am an old man, and some of the things I remember best never really happened." But it is true that about 20 years ago I served as General Counsel to the Federal Reserve Board.

Mr. LAFALCE. All right. I think it is important for us to know that you know a little bit about the workings and activities of the Federal Reserve Board and take that to the table with you.

Ms. Tanoue, at the near conclusion of Secretary Rubin's remarks, Chairman Leach indicated that he always gets a comfort factor, as do I, when the professionals can come to a meeting of the minds. I think that is very, very helpful. But I view you and your predecessors as the quintessential professionals because you are the insurers. Everybody else can talk about it, but you are the insurers, and that is why I look at your experience and your predecessors with special care.

And if anybody were at the table to help resolve the issue, for example, of operating subs, or the appropriate mixture, if any, of banking and commerce, I would like it to be those individuals who are responsible for insuring it, the funds in question.

If we ever have enough time, I am not going to ask for this officially, Mr. Chairman, I think it might be a great idea to have a panel of all the present, past and living chairmen of the FDIC to get their perspectives on this issue and their rationales. I think that would be extremely helpful, informative and influential.

What experience have you had as insurer for State-chartered institutions that have operating subsidiaries pursuant to State law?

Ms. TANOUE. We have had years of experience with operating subsidiaries of State-chartered non-member banks. And the activities undertaken by such entities, in many cases, are those that are contemplated by the OCC under its Part 5 rules.

I think it important to note that, in acting on those types of applications, the FDIC has developed a number of safeguards and firewalls that are very similar to those that are under discussion today; and while we have not had large numbers of institutions engaging in these activities, we have not found major concerns in terms of safety and soundness.

Mr. LAFALCE. All right. Fine. Your testimony does not need clearance by anyone, by OMB? You are an independent insurer?

Ms. TANOUE. Absolutely right.

Mr. LAFALCE. OK, good.

Why did you come forth with a defense of the unitary thrift holding company structure in your prepared testimony? You did specifically say that you had experience with them, you insure these institutions, and you did not like provisions of the law that would either eliminate or at least curtail the option before a unitary thrift respectively. Am I correct in what you said?

Ms. TANOUE. Yes. We did point out——

Mr. LAFALCE. Could you expand upon that?

Ms. TANOUE. In terms of the competitive landscape, we did not see a public policy purpose supporting a position which would, in effect, put a moratorium on such activities.

Mr. LAFALCE. All right. Now I have never asked the past chairman of the FDIC that question. I have asked them all the question about operating subsidiaries. Do you know offhand what their position would be on a moratorium with respect to a determination of the unitary thrift holding company charter prospectively?

Ms. TANOUE. I do not know, offhand, their positions.

Mr. LAFALCE. All right, fair enough.

Mr. Hawke and Ms. Seidman, to what extent does your testimony need clearance by the Administration, OMB? Mr. Hawke, does it need clearance?

Mr. HAWKE. No, Mr. LaFalce, it does not.

Mr. LAFALCE. Ms. Seidman? Does it?

Ms. SEIDMAN. No, it does not. Although, as a courtesy, we let them know what we are about to submit.

Mr. LAFALCE. OK, that is fine. I just wanted to clarify that.

Mr. Hawke, let me not ask you to give either your opinion, but let me just ask you to clarify a bit of history for me, if I might.

When you were the Assistant Secretary of the Treasury for Financial Policy, the immediate superior of Mr. Carnell, did not you and Mr. Carnell appear at least before committees—I can't remember whether it was official hearings or private meetings—and say, with respect to the mixture of banking and commerce, that this was a policy judgment for the Congress to make? That you at least did not recommend one option or the other, but your perspective was that either there should be some specific law permitting appropriate mixture, to-wit, some appropriate basket coupled with a termination of the unitary thrift holding company charter, or if there were not a specific provision allowing some appropriate mixture, a

retention of that unitary thrift holding company option perspectively? Am I remembering correctly?

Mr. HAWKE. Mr. LaFalce, when I was Under Secretary for Domestic Finance, I testified before this committee on the Treasury proposal. And, in that proposal, we outlined two alternative ways of dealing with the issue, suggesting that the Congress consider those or any other choices that it saw fit. One was to provide a modest basket permission for nonfinancial activities for holding companies, in which case we thought that would provide a framework for unifying the thrift charter with the bank charter and unifying regulation of holding companies. Alternatively, if no basket were thought appropriate, you might keep the unitary thrift in existence as it is today together with the thrift charter.

The purpose in either case——

Mr. LAFALCE. That is my recollection. I just wanted to have you refresh the historical record.

Ms. Seidman, you—since the 1960's, you and your predecessors have been supervising unitary thrifts, permitting them or not permitting them, and so forth, and evaluating them. To what extent, in your judgment, has the unitary thrift charter caused safety and soundness problems or other types of problems? To what extent has it been beneficial from a safety and soundness and economic perspective? What are the—what is the—give me an historical evaluation of the advantages and disadvantages of that approach.

Ms. SEIDMAN. Historically, I think we can say that the unitary thrift holding company charter has been, on balance, beneficial. I think it is extremely important, however, to divide the period into at least three parts, but definitely two, namely, before 1989 and after.

Since 1989, a tremendous number of restrictions and limitations have been put on the interactions between a thrift and its commercial or non-bank affiliates that didn't exist before; and such things as thrift investment in real estate development had been very severely curtailed.

But the fact is that we can actually trace a minimum of $3 billion in capital that was infused into 79 thrifts during the late 1980's and early 1990's by commercial firms. And, in fact, we are certain that much more money ultimately went in, but that is what we can trace by the capital infusions.

In a number of cases, Ford Motor Company being the most obvious, the commercial entity decided that having a thrift wasn't for them. They successfully sold the thrift, but it had been significantly rehabilitated, and a huge amount of capital had been put in that thrift by Ford before it was sold.

Chairman LEACH. Mr. Vento.

Mr. VENTO. I appreciate the line of questioning that my colleague has pursued with regards to this matter and, you know, completely concur. Obviously, I wanted to go a little further, but apparently he doesn't want anyone to have to dig a deep hole that they might—that may be uncomfortable for them to be in.

Chairman Leach, my concerns spring from the go-go 1980's when we thought, or at least some thought, the best way for financial institutions to dig themselves out of the hole was to have new activities and direct investment, a variety of other things that took place

by sometimes State-regulated institutions, sometimes federally-regulated institutions, was fundamentally proved to be a mistake.

But I think a mistake perhaps wasn't in the powers, but in the lack of what happened in terms of regulation; and, you know, I think that, you know, perhaps we should have known better than to give the power. I think we are sort of on the threshold issue of that today, and I think caution with regards to commerce and banking is justified.

But I mean, on the other hand, I don't think we can be blind. I think there is a testimony here that pointed out that the Chrysler Daimler-Benz merger, that Deutsche Bank owns 25 percent of that, which will deliver them to the United States of America to do banking under whatever subsidiary or under whatever they are going to do it.

So you have got a commerce banking subsidiary type of activity to finance, you know, the purchase of my new, hopefully, new Dodge Caravan or something, you know. Well, I got grandchildren. I have to put them in something.

So I mean the concern is that it is here. And I think that, you know, this sort of denial by those that have reservations about it is what I have a problem with. Apparently, consistency doesn't matter to them, I mean, because you have got all sorts of examples of State and other institutions that are doing this.

But let me just ask a question. In this bill that we have before us, I mean, it is one thing to be inconsistent with, but we have all kinds of special exemptions through banking and commerce, but one of the—couple new policies areas here—I will leave the CEBA thing alone—is the 15-year grandfather for the insurance and securities firms.

Now, Mr. Goldschmid, you don't disagree with equity involvement on the part of securities, or on brokerage dealers; is that correct? You agree with that?

Mr. GOLDSCHMID. Correct.

Mr. VENTO. And do you think—so that is going to be something that you think that—obviously, in terms of the merger, it is sort of indifferent toward you, I guess, whether or not they become—they have a bank holding company or not, but they will be able to have one I guess for 10 or maybe 15 years depending on what happened.

Mr. GOLDSCHMID. Our concern is that the Securities and Exchange Commission's securities law apply. We are very flexible about forms.

Mr. VENTO. Mr. Hawke, what do you think the effect would be in terms of national banks and banks holding companies in light of the fact that a—predominantly insurance or predominantly securities—firms could, in fact, have banks and that existing national and holding company apparently could not? What do you think would be the evolution of the impact upon our financial system if this particular asymmetry were to persist? Asymmetry being out of balance.

Mr. HAWKE. Well, I object to discrimination whenever I find it in this legislation.

Mr. VENTO. God bless you.

Mr. HAWKE. Let me say, Mr. Vento, I think the problem that the Congress is confronting in this debate is not really whether to open up the doors to banking and commerce, because I don't think anybody is really arguing that. The marketplace is certainly not arguing for that. The problem has been right from the start, and the reason that we proposed the two alternatives that I mentioned before, was that you have the practical reality that some firms that we want to bring in under the tent, some insurance and securities firms, have some measure of nonfinancial activity today. The challenge has been how to deal with that. How do you accommodate that and get them in on a level playing field with other organizations? And that has been a very sticky issue.

Mr. VENTO. Well, part of is dependent upon how you define some of these instruments. I mean, if some people have their ways in terms of derivative is going to be more like an equity-type piece of paper. I mean, it could conceivably, in my mind, go in that direction. It depends upon how you define it.

Mr. Goldschmid, looking at your testimony, if I can find it here for a minute, the discussion arose with regards to page 12, the uniform mutual fund advisory regulation. Accordingly, all parties that provide investment advice now to mutual funds should be subject to the same oversight, including Commission inspections and examinations.

Now, banks and thrifts are examined almost yearly. How often are securities brokers and these institutions examined?

Mr. GOLDSCHMID. Well, we have gotten the numbers down; and we are doing sweeps. I couldn't give you an exact number today.

Mr. VENTO. Was it yearly or is it more than that?

Mr. GOLDSCHMID. I think it is probably still more. But it varies with the number and the size and other risk factors. But it is working—I mean, the point here is to keep in mind when it is in a bank—right now, for instance, a bank can act as the investment adviser. Because the 1940 Act didn't contemplate banks doing this, the investment adviser to the mutual fund could be considered an independent director of that fund.

Loans to the bank at disadvantageous rates can be made without our ability to pick that up. There are very serious problems right now that we are trying to reach. And on our compliance program, I think everyone has agreed it has grown more and more effective.

Mr. VENTO. I want to ask you about some of that. But I was, you know, informed—the last study that I had seen on this that was done by the General Accounting Office suggested it was five years.

Mr. GOLDSCHMID. Yes, that number I think has come down. I was quite critical as an academic of that number.

Mr. VENTO. Well, I appreciate that. And, you know, but since we think that there ought to be this parity and this symmetry and so forth, this is not quite fitting into that particular—you know, the concern here, I think I expressed it looking at, you know, from the standpoint of financial institutions is that discount brokerage and other types of activities which I think—what we are trying to do is leave—do no harm in terms of what the banks can generally do today. And if they are large enough, of course, this doesn't matter.

So it is the smaller institutions that might do discount brokerage and do other types of activities, that when we come down on them,

they say, "Well, what is in this bill for me?" They end up not being able to do some of the activities they can do today, insurance, which isn't your bailiwick, but certainly discount brokerage and sale of these, and that is the concern we have.

And I think that we are looking for—I mean, the real issue here is that, say it has to be our way or no way is a concern. I mean, listen, we have written State laws, myself, many of us have done work, and we know that States have different laws. And I mean Minnesota passed its own law and subdivided land sales practices. So I remember writing it. So there are a lot of differences between States and what the practices are even today that you have to coordinate.

It seems to me coordinating with half a dozen regulators in terms of national banks or bank holding companies or thrifts and so forth, wouldn't be, or shouldn't be, a major problem, especially if we set up an interagency or interdepartment type of arrangement.

But one of the things that I would like—last year when we were in the midst of trying to deal with the issue of banks and securitization and so forth, we, of course, had the celebrated *Nations* case, in terms of the fines that came down; and, of course, this apparently was the only fine and trespass in some individual's mind that had occurred in recent memory. And it was—it received a terrific play in *The Washington Post* and on the House floor and other places.

So what I would really like, I think, is to know, and you just, of course, commenting about these aggressive enforcement actions, that is exactly what I would like to know about, is I would like—for about the last three years, I would like the major enforcement records, the fines, penalties and other activities that SEC can place. I am sure you have a longer list, but I am not asking for all the small things, just the major enforcement actions. Could you comment a little bit on that?

Mr. GOLDSCHMID. Major enforcement actions?

Mr. VENTO. Yes.

Mr. GOLDSCHMID. Sure, we would be to happy give you a list.

My testimony cites another bank situation that we just brought an action, the *Traba* case, and we would be happy to develop a list for you.

Mr. VENTO. Not just banks. Of course, we would like to invite the scope of all of the different groups that are sitting. We treat them all even——

Mr. GOLDSCHMID. We will give you a full list of the enforcement cases. They run about roughly 500 a year. And then you have got to add to it the enormous security system that goes with the NASDR and others. They bring roughly 500 or 600 cases against brokerages.

Mr. VENTO. Perhaps we can get some common understanding just to deal with the major cases, so we can actually use the information, as opposed to just giving you on an even-handed basis.

Mr. GOLDSCHMID. I am just giving you a good feel of the nature of our enforcement process.

Thank you, Mr. Chairman.

Chairman LEACH. Thank you.

Mr. Bentsen.

Mr. BENTSEN. Thank you, Mr. Chairman.

Mr. Hawke, I have sort of a two-part question for you; and I ask it in two ways, one, in your capacity as the head of the OCC—and whatever capacity that is, I guess, that is an acting head of the OCC——

Mr. HAWKE. I am the Comptroller of the Currency.

Mr. BENTSEN.—and, second of all, from your both academic and professional background in the law.

We have had a lot of discussion today about the operating subsidiary, which you are quite familiar with, and the issue of risk. And, again, I will restate, as you may know, yesterday Chairman Greenspan reversed his previously-held position that he didn't believe there was a safety and soundness issue. He now, upon reflection over the last year or so, believes there is a safety and soundness issue.

But, from a legal perspective, is it possible to construct a subsidiary of a bank, a limited liability subsidiary where there is a non-recourse investment on the part of the bank where you can upstream dividends from the subsidiary to the parent, but you cannot upstream liability, except in the instance of malfeasance on the parent's part?

Mr. HAWKE. Mr. Bentsen, I think that is precisely the nature of the operating subsidiary. An operating subsidiary is a business corporation that enjoys the usual limited liability of any business corporation, and the fact that it is owned by a bank doesn't expose the bank to any greater liability for the subsidiary's obligations than the bank would be exposed to with respect to an affiliate.

Mr. BENTSEN. And would case history support that?

Mr. HAWKE. Yes, I am not aware of any case in which a bank was held liable for the obligations of an affiliate or a subsidiary that it had not explicitly and lawfully assumed.

Mr. BENTSEN. The sheet that was handed out that lists most common non-bank subsidiaries of bank holding companies and banks, is that yours?

Mr. HAWKE. Yes.

Mr. BENTSEN. That is yours. Do you all have any history of the failure and liability associated historically with these entities, you know, compared between bank holding companies and national banks? If you don't have it, you can get it for the record. I am just curious whether or not there is any pattern or consistency.

Mr. HAWKE. We would be happy to look into that.

In that connection, Mr. Bentsen, if I may, there has been some reference to the *First Options* case, which is given as an example of a problem with a subsidiary. I would like to submit for the record, and I know somebody on the committee asked for this earlier, the testimony of one of our people back in 1988 that gives the full story of *First Options*.

Mr. VENTO. Can I ask with unanimous consent that be put in the record?

Chairman LEACH. Without objection, it will be put in the record.

[The prepared statement of Hon. Emery W. Rushton can be found on page 795 in the appendix.]

Mr. HAWKE. The quick explanation is that when the OCC approved the establishment of First Options, it voluntarily imposed on First Options—on the bank's relationship with First Options—a lending limit constraint that did not exist as a matter of law. When First Options got into trouble, it asked for that limit to be relieved; and the OCC denied the request. The bank went ahead and advanced credit in violation of that restriction.

When the OCC found out about it, it immediately required that transaction to be reversed; and the funding was placed in the holding company. So, First Options, contrary to being an example of a situation where the subsidiary format exposed the bank, was a simple example of a violation of law that could have occurred with an affiliate or a subsidiary.

Mr. BENTSEN. And the liability from that instance—I have read one or two papers on this, but the question I would have on that, the liability in that particular instance then, would not be some structured liability. It would be liability on—a legal activity on the parent's part; and, thus, a creditor would not be able to come back to the parent and claim, because of the structure and the fact that an illegal advance of credit had been made, therefore, it opened the parent up to other claims. It would only be that the parent had acted improperly as it related to the subsidiary?

Mr. HAWKE. That is absolutely right. It was a debtor-creditor relationship between the parent and First Options or the holding company and First Options. And that, I don't think, under the piercing-the-corporate-veil doctrine would have been enough to justify imputing liability to the bank.

As a matter of fact, the one study that we found on this question of piercing the corporate veil indicates that it more frequently occurs—I am not talking about banks, I am talking about corporations generally—with respect to affiliates than with respect to subsidiaries. But the critical issue is a factual one in each case, that is, whether the principles of corporate separateness are being observed between the two institutions. And if corporate separateness is being observed, then the normal principles of limited liability should apply.

Mr. BENTSEN. And with the Chairman's indulgence, in the difference between the operating subsidiary structure and the affiliate structure—and I would ask Mr. Goldschmid this as well, who I think said that you were flexible about form, or the SEC, was flexible about form, which I think is also a different—a newer position—is there more functional regulation under the operating subsidiary structure as it relates to securities investment product sales than under the current affiliate structure like a Section 20 or a proposed affiliate structure?

Mr. HAWKE. It would be identical.

Mr. BENTSEN. Identical.

Mr. GOLDSCHMID. In the past, the Commission—of course, when we talk about holding companies and op-subs, the definitions have been changing. In the past, the Commission has thought it was easier to work in a holding company format, but we want to look at where things are today. The key I should say for us is that the SEC continue its regulatory responsibility.

Mr. BENTSEN. For the record, Mr. Goldschmid, if you would—I am sure you will do this anyway, but if you would provide for me the—where the SEC sees potential loopholes as it relates to consumer protection and proper regulation and enforcement of securities sales and other investment product sales under—currently under the regulation of the SEC as it relates to broker-dealers in both H.R. 10 and H.R. 665.

Mr. GOLDSCHMID. We would be happy to do that.

And I should say, on investment advisers, the current H.R. 10 is a good bill from our standpoint. It does give us the authority we need over those investment advisers.

Mr. BENTSEN. All right. Thank you.

Mr. HAWKE. Mr. Chairman, if I could have the Chairman's indulgence for just one moment to address a point that Mr. Bentsen raised earlier with respect to the accounting treatment of banks and operating subsidiaries.

I think it is important to distinguish between financial reporting conventions and economic realities. When bank examiners go into a bank, as Congressman Bachus observed, they will look at a bank's consolidated balance sheet. But what they really look at are the assets and the real value of the assets, and they look at regulatory capital. And regulatory capital is different from GAAP capital. They will also look at what really is at risk with respect to the bank's investment in the subsidiary.

What is at risk is the amount of equity that the bank has invested in the subsidiary, plus any credits that the bank has, within legal limits, extended to the subsidiary. That is where the real risk, if any, to the bank is; and it should be measured on that basis.

Financial reporting conventions would consolidate the subsidiary into the bank, but that doesn't give a true measure of what, for example, the FDIC exposure is. Because if the bank or the subsidiary fails, the bank's exposure is only the loss of the investment that it has in the subsidiary. And if the bank is required to maintain its capital at the well-capitalized level, then the bank should be able to withstand the failure of the subsidiary and still be well-capitalized on a regulatory capital basis.

Mr. BENTSEN. And the equity investment would be over and above the regulatory capital of the bank; correct?

Mr. HAWKE. That is right. It would have to be subtracted from the regulatory capital of the bank in determining whether the bank was, on a stand-alone basis, well-capitalized.

Mr. BENTSEN. And to the extent that the examiners—and I don't know what they look at, but to the extent that the examiners look at the management capability of the bank itself, would it not be the same? That whether it is a national bank structure or a holding company structure, that a poor performing subsidiary or poor performing affiliate would be viewed in the same way where you had a dominant parent or dominant bank within the holding company structure?

Mr. HAWKE. Yes, I think that is absolutely right.

Mr. BENTSEN. Thank you, Mr. Chairman.

Mr. VENTO. Mr. Chairman.

Chairman LEACH. Mr. Vento.

Mr. VENTO. I want to just refer to Appendix B that Chairman Tanoue has actually provided for us and just a query as to whether or not—we don't have numbers, apparently, on most of the State banking commerce type of activities; and I don't know what that definitively—it looks as though the focus—it gives some general history in terms of State roles historically, but doesn't necessarily come to a conclusion today. We need help in this example. The Nordstrom example that Director Seidman has pointed out—if that was a State-chartered institution?

Ms. SEIDMAN. No, as a matter of fact, Ms. Williams has pointed out that I made one mistake. It is a national bank, but while it is not subject to most provisions of the Bank Holding Company Act it is indeed subject to Section 23(a). Were it to become a thrift, were we to approve the charter, it is a post-October applicant.

Mr. VENTO. That is the newer applications.

Ms. SEIDMAN. It would be to stricter rules that are appropriate under——

Mr. VENTO. But under the loose, liberal rules of the OCC it is not affected.

Ms. SEIDMAN. No, not the loose, liberal rules of the OCC. My point is that for many of these so-called banking and commerce issues there is a tremendous amount of intermingling already in the system.

Mr. VENTO. I know that, but I am trying to get a fix, if anyone can help me, in terms—I appreciate Appendix B, but what I think we would like is to have information in terms of what is happening where the State is. For instance, the chart that Comptroller Hawke gave us, does that include State activities, too, Mr. Hawke?

Mr. HAWKE. This looks at both bank holding companies and, I believe, national banks.

Mr. VENTO. And so it does not include State?

Mr. HAWKE. I am reminded that the chart includes both national and State banks.

Mr. VENTO. Well, that is one of my difficulties in terms of trying to arrive at—I don't know. It is sort of like someone who is designed against their opinion is of the same opinion still. I don't know if I will change any minds with it, but it is nice to have the ammunition.

Chairman LEACH. Mr. LaFalce.

Mr. LAFALCE. Ms. Tanoue, yesterday consumer activist Ralph Nader expressed concern with what he said was the inadequacy of the insurance fund to meet potential future difficulties. Because of the size of the fund you are not even charging premiums now, but you should be assessing premiums to build the fund up much, much more so. Because these are good times, and if we did have bad times we need a more adequate rainy day—especially in contemplation of passage of legislation that would permit affiliation and ever larger institutions. And what are your thoughts on that?

Ms. TANOUE. That is one of the subjects that we are currently studying. We are looking at the current circumstances and the potential exposure presented by these very large and complex institutions and we are looking at the adequacy of the 1.25 percent DRR. We hope to have that work done by June.

Mr. LAFALCE. Independently of affiliations, you presently have operating subsidiaries in a number of the institutions, at least chartered under State law, some national banks, too. Well, you have a number of activities that could have been performed within the bank, but other recent regulations promulgated by the previous comptroller. You now have some activities that—in op-subs—that arguably might not have been permitted within the bank itself.

You have assessed risk-based premiums; is that correct?

Ms. TANOUE. Yes.

Mr. LAFALCE. To what extent does the determination of the appropriate risk-based premium consider the activities in op-subs? Does it raise the premium? Does it lower the premium? Or does it do both, depending upon the activity of the sub?

Ms. TANOUE. I am not aware of any direct correlation between the activities that an op-sub might engage in and the determination of premiums.

But, again, I really appreciate the comments you made earlier about the FDIC. We are an agency that very much prides ourselves on being a neutral broker. We have looked very carefully at this issue of safety and soundness as it pertains to either approach, the bank holding company affiliate structure or the op-sub approach, and I would like to emphasize that we believe strongly that the safeguards that have been discussed that are necessary to protect the insurance funds are similar under either approach. And so long as those safeguards are maintained—and I would emphasize are enforced—we feel either approach is viable. And certainly that is why we put forward our position today that we would encourage the committee to allow institutions the choice and the flexibility to choose the appropriate organizational structure.

Mr. LAFALCE. Thank you.

Thank you, Mr. Chairman.

Chairman LEACH. Thank you. I have a few questions.

First, Mr. Goldschmid, you also are an independent agency that does not——

Mr. GOLDSCHMID. That is true.

Chairman LEACH. Is your preference for the holding company structure or the operating subsidiaries approach?

Mr. GOLDSCHMID. The concern is about our regulatory responsibilities. I think that we have in the past said there is an administrative advantage to the holding company structure.

Chairman LEACH. Thank you.

A year or two ago, the Treasury had a little bit of a different position on the issue of banking and commerce, and now it apparently is against. And I take it that you are against, Mr. Hawke, and you have reached that judgment independent of the Treasury; is that correct?

Mr. HAWKE. Mr. Chairman, I did not address that issue in my prepared statement. I have been intent on focusing on the interests of national banks and making sure that those interests are not adversely affected.

Chairman LEACH. So you are not opining on the issue?

Mr. HAWKE. I am sorry.

Chairman LEACH. I meant that facetiously.

Less facetiously, Ms. Seidman, it has been suggested here that there is no great history of problems of the unitary thrift in terms of obligations to the fund. The Secretary of the Treasury of the United States has indicated that. He has also indicated that he has had some concerns looking at the world situation, particularly in Asia.

Do you know any evidence—as you are an independent individual, as you look at Asia, do you have a lot of comfort in the keiretsu kind of system? Do you like the mix of commercial owner and financial institutions? Does that give you comfort?

Ms. SEIDMAN. Mr. Chairman, obviously, the Asian situation is not one to be emulated. On the other hand, I think there are some very important differences both between the Japanese financial system in general and the American system. The transparency of the securities and debt markets, the degree of effective bank regulation, the effectiveness of the accounting rules, the transparency of the accounting rules, all of those are very, very different.

Mr. LAFALCE. The governmental influence over the decision-making process?

Chairman LEACH. Let me turn to a different question then. You are an institution that oversees the American thrift industry of which unitary thrifts are a part. Do you recall that in the 1980's losses accumulated in this industry, losses that cost the public $130 billion and that figure is still rising? And are you aware that in those losses, and it is unquantified, but clearly in the multibillion dimension, are losses related to what are called "direct investments," which was the intertwining of commerce and banking within the American thrift industry?

Ms. SEIDMAN. Mr. Chairman, one would have to have been not aware at all during the 1980's to have missed that.

Chairman LEACH. Thank you. Let me go on——

Ms. SEIDMAN. Let me say that the Congress responded to that; and there are many, many changes that were made in FIRREA and FDICIA, one of the most important being a severe restriction on the ability to do real estate investment in a subsidiary so that less than .04 percent of thrift assets are now in real estate subsidiaries. So that, yes, there was a problem. It was not a unitary problem, and it is a problem that Congress intervened with your leadership to resolve.

Chairman LEACH. Are you aware that in the last Congress we transferred from institutions under your jurisdiction $6 billion to $8 billion in liabilities to the commercial banking sector?

Ms. SEIDMAN. Mr. Chairman, that is the issue of the payment under which the FICO bonds would be paid.

Chairman LEACH. That is correct, with your institution's strong recommendation and also the FDIC's. Now the reason I raise it, the subsequent question, is, particularly in the light of a transfer of obligations, is there any case for institutions under your jurisdiction that had their cost structure lessened by transferring to another set of competitors who had their cost structure increased for your institutions to maintain a privileged charter?

Ms. SEIDMAN. Mr. Chairman, I would maintain that the charter of the thrift industry is not, indeed, a privileged charter. And it is a charter that has balances. The institutions that I regulate do not

do a significant amount of commercial lending; and, in fact, one institution in California has just announced that it has reached the commercial lending limits and so it is going to flip charters.

Chairman LEACH. An institution in my hometown has taken the reverse position, because they like the capacity under your institution to make what, in effect, are direct investments.

Let me just conclude by saying that, first, with regard to your Nordstrom model, it was my understanding that was not a commercial bank, but a credit card bank, and that comes under a substantially different framework. And so when you repeat the story I think it is very important that you make that clear, because that is one of the reasons that the OCC may not have exactly the same rules and regulations.

Ms. SEIDMAN. And the Nordstrom's proposal that has been submitted is a credit card proposal.

Chairman LEACH. Correct. Right.

Let me just conclude by saying that I recognize that everybody in this panel has a little different judgment on a spectrum of issues, but is it fair to say that you think that the American financial system and the American economy would be bolstered by financial modernization legislation, reserving the right to differ on aspects of its composition? Is that fair for you, Mrs. Tanoue?

Ms. TANOUE. Yes.

Chairman LEACH. Would it be for you, Mr. Hawke?

Mr. HAWKE. I would completely agree with that, provided that in the process we don't——

Chairman LEACH. Your views are taken into serious consideration.

Mr. HAWKE. I wasn't going to put it that way, but——

Mr. LAFALCE. That is the way Mr. Greenspan put it.

Chairman LEACH. Ms. Seidman.

Ms. SEIDMAN. I think it is important that it be the right legislation, but certainly there is room for a tremendous improvement in the system with good legislation.

Chairman LEACH. Good.

Mr. Goldschmid.

Mr. GOLDSCHMID. Yes. The Commission fully supports modernization, but we do need good legislation.

Chairman LEACH. Fair enough.

Well, I think, on behalf of Mr. LaFalce and I, we share a desire for good legislation; and so I think we have unanimity at the two tables.

Thank you all. This brings our hearing to an end.

[Whereupon, at 1:14 p.m., the hearing was adjourned.]

APPENDIX

February 10, 1999

CURRENCY

Committee on Banking and Financial Services

James A. Leach, Chairman

For Immediate Release:
Wednesday, February 10, 1999

Contact: David Runkel
(202) 226-0471

Opening Statement
Of Rep. James A. Leach
Chairman, House Banking and Financial Services Committee
Hearings on H.R. 10, Financial Services Act

Today we begin the first of three days of public hearings on legislation to modernize our nation's archaic, Depression-era banking laws, which were long ago overtaken by market developments.

This is, as everyone here knows, an issue which has been under consideration in Congress for several decades. Last fall we came close to achieving consensus and the bill before us reflects compromises hammered out over four years of consideration.

Today, we are starting off these hearings with broader support for the legislation than has ever existed before. An impressive number of large and small commercial banks, regional and money-center securities firms, insurance companies and agents support the approach on the table.

The bill before us was introduced by myself, Vice Chairman McCollum, the chairs of all of our subcommittees and other Members. A bill with similar goals will apparently be introduced later today by Mr. LaFalce, which reportedly will largely have Administration support. I consider this to be a constructive addition to the policy dialogue.

Thus, I hope we are on the final lap in winning Congressional approval of financial services modernization.

In conclusion let me stress that if we fail to move on legislation of this nature, American international preeminence in financial markets will come into question, American consumers will be denied the benefits which would flow from greater competition within the financial arena, and many rural areas will be precluded access to a broad-range of financial products. Here, let me remind everyone that two years ago, Treasury Secretary Robert Rubin estimated that consumers could save an estimated $15 billion annually as a result of passage of modernization legislation.

In the interest of time to hear from our distinguished witnesses, I will recognize Mr. LaFalce for an opening statement. Following Mr. LaFalce, I will recognize the chairman and the ranking member of the two subcommittees with primary jurisdiction – beginning with Financial Institutions and following with Capital Markets.

Mr. LaFalce you are recognized for three minutes.

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Luis V. Gutierrez

Congress of the United States
House of Representatives
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OPENING STATEMENT

CONGRESSMAN LUIS V. GUTIERREZ
COMMITTEE ON BANKING AND FINANCIAL SERVICES
FEBRUARY 10, 1999

Mr. Chairman, I would like to welcome today's witnesses and thank them for appearing before this Committee. I also want to recognize the great amount of energy and time that you, Mr. LaFalce and your staffs have committed to the issue of Financial Services Modernization already in the 106th Congress. The issue before us is extremely important: How best to amend current laws that restrict the ability of banks to affiliate with other financial entities, including securities firms, insurance companies and possibly commercial firms.

While updating our laws will likely help the banking and financial industries maintain their strength into the 21st Century -- and to offer new products to many consumers, financial services modernization also provides two additional important opportunities. Through financial services reform, we have an opportunity to ensure that investment in communities in great need of capital improvements, new housing and commercial development is not only maintained but is increased. We also have the opportunity to address soaring bank fees and a growing lack of access to basic bank services for many low-income consumers. My hope is that we can work to not only protect the Community Reinvestment Act through financial services reform, but to also strengthen it.

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Opening Statement: Banking Committee February 10, 1999
Darlene Hooley

I would like to thank the Chair for holding hearings on financial services reform so early in our legislative session. That we are having these hearings today only underscores the importance of the task before us.

It is essential that we come to agreement on a bill. Mergers such as the one we saw between Travelers Group and Citicorp last year show us just how antiquated our laws governing these industries are. We have also seen that Wall Street and Main Street are not waiting for Congress to act. With each merger and acquisition, the laws we currently have in place become increasingly out-of-date and ineffective.

Last year this Banking Committee marked up a bill that was able to garner the support of members of the banking, insurance, and securities industries as well as the support of my colleagues on both sides of the aisle. I am confident that we will be able to work, once again, to bring all interested parties together to produce a bill-- one that will allow our financial services companies to meet the global competitive demands that will be placed upon them in the 21st century.

Therefore, I urge my colleagues, as well as the representatives of the various industries before us today, to work together to resolve the remaining differences and pass a bill this year.

I yield bank the remaining balance of my time to the Ranking Minority Member.

PAUL E. KANJORSKI
11TH DISTRICT, PENNSYLVANIA

COMMITTEE ON BANKING AND FINANCIAL SERVICES

RANKING MEMBER
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OPENING STATEMENT OF CONGRESSMAN PAUL E. KANJORSKI

HOUSE COMMITTEE ON BANKING AND FINANCIAL SERVICES HEARING ON FINANCIAL SERVICES MODERNIZATION

WEDNESDAY, FEBRUARY 10, 1999

Mr. Chairman, thank you for allowing me to speak briefly about my views on the financial services modernization legislation pending before our Committee. President Lincoln delivered the Gettysburg Address in my home state of Pennsylvania in just under three minutes, and I will endeavor to keep my remarks as short today.

First, let me begin by commending the efforts of the Chairman and the Ranking Member to develop legislation addressing the complex issues of how to modernize our nation's financial services system. Before I can support any bill, however, I hope that it would address my concerns. As you know, I serve as the Ranking Member of the Subcommittee on Capital Markets, Securities, and Government Sponsored Enterprises. From this position, I have developed some keen insights about our nation's financial services industry.

From my perspective, I question whether we need to break down the barriers that presently separate banking and commerce. Even as I speak, other economies around the world are in turmoil. In Japan, for example, it appears that the cozy network of *keiretsu* financial dealings may have led to the great inefficiencies that produced their present economic disorder. Before imposing such dramatic changes on our economy, we should take the time to learn the lessons from the world around us.

Additionally, I hope that any bill to modernize our nation's financial services will provide consumers with adequate, if not superior, protections. Congress must take steps to protect the privacy of individuals. Competitive markets also require that customers have perfect information, and we need to ensure that consumers have the resources that they need to make the best choices.

Finally, we must ensure that <u>every</u> community will share in the rewards of modernization before moving forward. We should, in particular, guarantee that our actions will help small towns and not crowd small banks out of the financial marketplace. Community bankers play an especially important role in our financial system. On this note, later today our Committee will take the testimony of E. Lee Beard, a constituent from my congressional district and President of First Federal Bank in Hazleton, Pennsylvania. Ms. Beard also serves as Chair of America's Community Bankers (ACB). Because ACB represents community bankers from across the nation, I will be especially interested in learning of her thoughts on financial services modernization. I also hope to learn ACB's views on modernizing the Federal Home Loan Bank System.

In conclusion, Mr. Chairman, while I do not at this time support or oppose any particular modernization bill, I do believe that this Committee must carefully consider many matters before it moves forward with reporting legislation to the full House. Consequently, I hope that in the 106th Congress we will have many more occasions to examine these issues and not rush to produce a bill.

Statement of Congresswoman Sue Kelly
Hearing on H.R. 10 -- Financial Services Modernization

Wednesday, February 10, 1999

Chairman Leach, Ranking Member LaFalce, I would like to thank you both for agreeing to hold this, the first in a series of three hearings on financial services modernization. I want to be brief and to the point. Enacting financial services Modernization is one of my highest priorities this Congress. I stand ready to work with all of my colleagues to refine H.R. 10 so that it receives broad support and is signed by the President. I am an original cosponsor of H.R. 10 this year and believe that we have a bill that has a very real opportunity for it to be enacted in this Congress.

Over the years we have worked hard on this legislation again and again to bring us to the point we are at today. Our financial services markets can no longer operate under a law written for the financial services of the 1930's as we enter the 21st century. With all of the advances of technology in the markets that could never have been foreseen almost seventy years ago we must make new a determination of what may or may not affect an institution's safety and soundness.

I'm pleased that I can sit here today and say that the House can pass financial services modernization. We proved that last year. The question now is can the Senate? But we will cross that bridge when we come to it.

Secretary Rubin has stated that the enactment of financial services modernization would mean at least a five percent reduction in costs to the consumer. That translates to as much as $15 billion a year, a nice savings to the public and assistance to the economy.

In short H.R. 10 is must pass legislation and enjoys my full support and attention. I stand ready to work with everyone who seeks to improve the legislation and stand against anyone who seeks to frustrate the process. I thank the committee for its past work on this legislation and look forward to making this time the charm time.

I thank our distinguished panelists for coming here today, taking the time out of their busy schedules to join us and discuss the finer points of H.R. 10. I look forward to exploring your ideas.
Thank you.

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SERVICES COMMITTEE

Opening Statement
Before the House Committee on
Banking and Financial Services
Financial Services Act
Rep. Frank Mascara
February 10, 1999

Mr. Chairman, Ranking Member La Falce:

It is a pleasure to participate today in this hearing on the most important issue facing this Committee in the 106th Congress.

I commend the Chairman for having assembled such distinguished panels of witnesses representing a wide range of interests.

This Committee has before it a tremendous responsibility to come to a resolution on the issue of financial services modernization. The rapid growth and technological advances in this industry are bringing changes that will continue without the help of Congress.

However, it is incumbent upon Congress to ensure that this evolution now taking place within the financial sector continues in a structured and fair manner. This can only be achieved by a comprehensive legislative effort to establish a sound foundation for financial modernization.

It is firmly within the public interest to ensure that this Congressional action provides for efficient markets, fair regulation, and strong consumer protection.

I look forward to hearing the testimony of our panelists during the next few days and am hopeful that Chairman Leach and Ranking Member La Falce can reach a bipartisan agreement on the legislation this Committee reports.

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Ron Paul

OPENING STATEMENT OF
RON PAUL
HEARING ON FINANCIAL MODERNIZATION
COMMITTEE ON BANKING AND FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES
10 FEBRUARY 1999

Mr. Chairman and Mr. LaFalce, I applaud your leadership efforts and extensive hearings on this important subject. As we consider reforming the regulatory structure in the fast-changing world of financial services, there are a few principles we should bear in mind. By standing firm for free market principles, we can better ensure productivity, growth, prosperity and consumer choice.

First and foremost, we should bear in mind the possible changes to taxpayer liability from different approaches. Federal Reserve Board Chairman Alan Greenspan correctly reminded the committee last year of what he termed the potential spread of the "sovereign credit" subsidy and the pitfalls of that possibility. Our first obligation in this process is to the taxpayer. Our constituents come first--always ahead of narrower special interests.

Secondly, the process of voluntary exchange between individuals (either singly or through membership in groups and institutions), i.e. the market, is the best allocator of resources. We should not downplay the importance of the indicators of the market pricing of credit. Interest rates should reflect the ratio that exists between savers' willingness to lend and investors' willingness to borrow. This constantly fluctuating ratio provides market participants the best source of information with which to make important financial decisions. The economic turmoil wreaking havoc around the globe illustrates the perils of ignoring the importance of the market pricing of credit risk.

Thirdly, we must be mindful of the law of unintended consequences. Outdated laws and regulations should not deny consumers the option of choosing new "hybrid" financial products and services that do not fit neatly into dated financial boxes. Often, well-intended regulations have the opposite effect in practice of the stated goal: since the cost of compliance of most regulations falls disproportionately hardest on the smallest institutions (the ones closest to their communities and most likely to be meeting the goals of regulations such as the Community Reinvestment Act), the regulations may cause a further consolidation of assets in the marketplace and limit consumer availability of financial services (such as rural or inner-city lending).

Lastly, the ever-accumulating weight of governmental regulations places a heavy drag on the economy and the country's financial competitiveness. As Mr. Greenspan explained to the Senate Banking, Housing and Urban Affairs Committee (February 22, 1995 and again on September 22, 1995), Congress should sunset all laws, institutions and regulations ("absolutely" including the Federal Reserve Act), "we have to find [a] means to at least counter that upward bias [of accumulating legislation]." Perhaps our best approach is to review and repeal existing laws, institutions and regulations rather than issuing new ones.

BOB WEYGAND
Second District, Rhode Island

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**STATEMENT OF CONGRESSMAN BOB WEYGAND
OF RHODE ISLAND**

House Committee on Banking and Financial Services

February 10, 1999

Thank you Mr. Chairman. Mr. Chairman, Ranking Member LaFalce. I am encouraged by the committee's proactive approach to Financial Services Modernization and commend the Chairman for holding these hearings on financial modernization legislation. It is my sincere hope that we will be able to work out a bi-partisan agreement that will make the United States more competitive in the global financial market place.

I just wanted to take a few minutes to address what I think are the critical issues that need be addressed when considering the overhaul of our financial services system. When we break the issue of financial modernization legislation down to it simplest form we are left with two fundamental questions. First, what effect will any legislation have on US financial institutions ability to compete in an ever increasing global market place? Second, what effect will that same legislation have on consumers? It is my belief, that whatever legislation we come up with should enhance the lives of everyday American consumers while improving the competitiveness of US financial institutions. Let me state at the outset, I am confident that we will be able to achieve these two goals.

In recent years, we have learned that modernizing our financial system is a complex process that will affect many industries and interests. It is important for us to develop a system that allows all industries, whether it be insurance, securities, banking, credit unions, or thrifts, to remain viable. That is, we must be careful not to structure legislation that will give one industry an unfair advantage over another nor can we allow one industry's competitiveness to come at the expense of another or at the expense of the consumer.

Thank you Mr. Chairman.

Testimony by

DAVID H. KOMANSKY
Chairman and Chief Executive Officer
Merrill Lynch & Co., Inc.

Before the

COMMITTEE ON BANKING AND FINANCIAL SERVICES
United States House of Representatives

February 10, 1999

Summary of the Testimony of
David H. Komansky
Chairman and CEO
Merrill Lynch & Co., Inc.

- The legal structure that separates banking from investment banking, insurance, and commercial activities is outdated and fraught with exceptions. Through regulator and judicial interpretations of existing law and marketplace pressures, financial services providers are increasingly competing across industry lines. But our laws limit full competition, restrict consumer choice, impose unnecessary costs, and dampen innovation, benefiting neither provider nor consumer.

- The House has a unique opportunity to act. Consolidation of firms and expansion of product offerings, both in the U.S. and abroad, will continue to take place, with or without legislation. It is important to establish the regulatory framework that can both grant the flexibility needed by firms to meet the needs of the marketplace and ensure appropriate supervision of large and complex institutions.

- H.R. 10 allows affiliations between all sectors of financial services under a holding company structure, ensures functional regulation of the subsidiaries, and ensures umbrella regulation of the holding company.

- Most of the industry's internal disagreements over affiliation and functional regulation have been settled. The outstanding issues are few and resolvable. Unlike years past, when legislative efforts deadlocked due to inter-industry turf fights aimed at forestalling competition, there is no disagreement in the industry about the basic structure of H.R. 10.

- Financial modernization will allow firms to better serve their domestic customers and meet international competition in an industry that is vital to the nation's future. But only with Congressional action can an even-handed and comprehensive structure for the financial services industry be achieved.

Introduction

Mr. Chairman and Members of the Committee, I am David Komansky, Chairman and Chief Executive Officer of Merrill Lynch & Co., Inc. I am honored to have the opportunity to testify before this Committee.

For more than a decade, we and others both in industry and government have argued that consumers and markets would benefit by unshackling the financial services industry from an antiquated legal structure. The provisions of the Glass Steagall and Bank Holding Company Acts, some of them devised over 60 years ago, were designed in response to a marketplace that no longer exists. There is a strong consensus in the industry -- and hopefully in this room -- that these rules restrict competition, reduce consumer choice, and are not necessary to protect consumers or insured financial institutions. Treasury Secretary Rubin testified in 1997 about the savings to consumers that would result from reform of our depression era financial laws. He stated that "it would not be unreasonable to expect ultimate savings to consumers of five percent from increased competition in the securities, banking and insurance industry -- as much as $15 billion per year. These savings would be substantially greater if you include costs to companies, as well as consumers."

Last year, this committee passed H.R. 10. The current version of H.R. 10 retains many elements of that bill and forms the foundation for swift action this year. This committee has a unique window of opportunity to pass major financial reform this year, and we think it imperative that you do so. Unlike years past, when we debated this issue on predictions of rapid changes in the financial markets, you are now addressing this legislation within a whirlwind of global financial industry consolidation. Over the last year, we have witnessed our international competitors both consolidate their resources and acquire a number of American financial institutions. Despite the consolidation occurring in the U.S., most of the largest financial services companies are today still headquartered outside this country. If our industry is to remain competitive around the world we must take steps to maintain the global preeminence of U.S.-based financial corporations and of our nation's financial markets.

The rapid evolution of banking, securities and insurance will not cease, and modernization will happen with or without legislation. Whether one applauds or decries the mergers that are taking place, it is important to establish the regulatory framework that can ensure appropriate supervision of large and complex institutions. Should Congress fail to act this year, the restructuring of the global financial industry will simply proceed while American institutions remain handicapped by antiquated laws.

The trick in reforming the regulatory framework is ensuring it enhances competition abroad, while also advancing competition here at home. I believe H.R. 10 achieves this balance, strengthening the hand of those of us that compete with foreign financial institutions here and abroad, granting new opportunities to financial companies here at home, while enhancing competition and consumer choice. I believe the legislation

represents a fair compromise that instills competitive parity between banks and other financial providers. The ultimate beneficiaries of this increased competition are American consumers and businesses, large and small, which will have a greater number of products and services to choose from, in a more convenient forum, and at lower prices.

Most of the industry's internal disagreements over this legislation have been resolved. No one questions the basic reforms proposed -- that banks and securities firms and insurance firms should be allowed to affiliate. Now is the time to put in place a workable system that will set the framework for the delivery of financial services in the new century and beyond.

Glass-Steagall and the Bank Holding Company Act

Our current financial laws were shaped in an economic era vastly different from today's. They were created for the America of the Great Depression -- long before electronic banking, emerging-market funds, or currency swaps were even imagined. But while consumer needs and the marketplace have changed considerably, the laws remain much the same. The central component of financial modernization is the repeal of sections of the Glass-Steagall and Bank Holding Company Acts that serve to separate our financial services industry into distinct sectors.

Glass-Steagall and Section 20 Affiliates

In the wake of the stock market collapse of 1929, it was felt that the best way to enhance the safety and soundness of banks, and to protect depositors, was to prevent banks from engaging in securities activities, particularly underwriting. So Congress enacted amendments to the Banking Act, known as Glass-Steagall, which generally prohibit banks from underwriting or dealing in securities and from affiliating with firms that "engage principally" in such activities.

Glass-Steagall contained exceptions to this blanket rule when it was enacted. For example, it permitted banks to underwrite and deal in U.S. Government bonds and municipal general obligation bonds. Over the years, the list of exceptions grew as bank regulators became convinced that securities activities could be conducted without jeopardizing banks, and additional sources of revenue could enhance bank safety and soundness. Ten years ago, banks were authorized to establish affiliates - known as Section 20 affiliates - to engage in securities activities that were ineligible to be conducted directly by a bank, for example the underwriting of corporate equity securities.

Today, bank holding companies may derive up to 25% of their revenues from the underwriting activities of Section 20 affiliates, and some of the leading underwriters are now bank holding companies. There have been 40 acquisitions of U.S. brokerages by banks since the expansion of Section 20 since 1997- and in nine cases the acquirors were non-U.S. banks. Thus today, even though the Glass-Steagall Act has not changed, banks have acquired many of our major securities firms including Alex. Brown; Wheat, First; Dillon, Read; Montgomery Securities and Oppenheimer & Co., just to name a few.

Bank Holding Company Act

The Bank Holding Company Act of 1956 is the other major law governing the structure of our financial services system. The Bank Holding Company Act, among many other provisions, requires that companies that control banks engage only in activities that are "closely related to banking." This is the law that separates banking from insurance and commerce, and prevents entities that engage in nonbanking or commercial activities from acquiring banks. In reality, however, the barrier between banking and other financial and nonfinancial activities has never been impenetrable. Insured financial institutions that are not "banks" under the Act, such as thrifts, credit card banks, industrial loan companies and grandfathered limited-purpose banks, may be owned by companies that engage in financial or commercial activities.

Just as non-banking financial and some commercial companies have made limited inroads into the banking business, bank regulators have interpreted existing law in a progressive manner to allow banks, in addition to the previously discussed securities activities, to expand their insurance operations. Such regulatory interpretations of existing law, though sometimes criticized, are responses to marketplace developments. Increasingly, financial services providers compete across industry lines. But true competition is still limited by law.

Changing Marketplace

What is the force behind these market developments? The needs of consumers of financial services have evolved and are, in turn, transforming the market. The current regulatory structure was put in place when the range of services available to the consumer, as well as the number of potential providers, was limited. Most financial services were obtained locally, more often than not from a neighborhood banker or insurance agent with whom the consumer was personally acquainted.

In today's marketplace, consumers, investors and businesses are not hesitant to obtain services from a variety of providers, some locally, and some located in distant states. While many consumers choose to obtain services from a trusted source with whom they are personally acquainted, others prefer the convenience of transacting business over the telephone or via the Internet. Consumers not only have access to financial information 24 hours a day, but can initiate financial transactions worldwide on a real time basis.

Consumer needs have prompted the development of financial services that were rare or unknown not long ago -- services like mutual funds, money market accounts, credit cards, mortgages, individual retirement accounts, home equity loans, stored value cards, and a variety of products geared to the business owner. Many of these new products are the result of an increasing level of competition by financial services providers across industry lines, providing alternatives to services once available only from a single source. Thus, money market mutual funds were developed by the securities industry to provide an investment opportunity for funds that consumers were holding in bank accounts. Banks

offer loan syndications and private placements of securities to business clients as an alternative to services offered by securities firms. Life insurance companies developed single premium annuities to compete with bank certificates of deposits.

Serving consumers is facilitated by increasingly sophisticated communications and information technology, which creates opportunities to handle information more efficiently and to develop improved products geared to the needs of each individual consumer and investor. Transaction costs and processing time are declining.

But while technology and competition offer the potential for better products and services, increased efficiency, and lower costs, the extent to which U.S. financial institutions can take advantage of these opportunities is limited by statutory and regulatory constraints. For financial services firms to function efficiently in today's complex and global economy, our financial services laws should be revised to parallel the changes in consumer and business demands and their savings and investment preferences. A new legal framework should recognize the blurring of distinctions between financial services products, the emergence of new financial services products, and communications and computer technology by which these products are made available. And it is imperative that this structure be flexible enough to accommodate future market developments without building barriers to competition through definitions of what is and is not a proper business activity for a firm offering financial services.

Pending Legislation

H.R. 10 offers a solid foundation for reform. It enjoys widespread support from virtually all sectors of the financial industry. It adequately addresses the issues surrounding the market driven integration of financial services. It allows for full affiliation of financial services -- banking, securities and insurance -- under one holding company. It contains a definition of financial that is inclusive and crucial to the development of future financial products. It would allow a bank holding company to bring a new product to market or engage in many new activities without the current cumbersome and time consuming application process. The bill establishes the structure for functional regulation, yet also grants to the Federal Reserve the ability to supervise the holding company as a whole. This gives regulators the tools they need to monitor the safety, soundness, and adherence to consumer protections of banks and their affiliated financial businesses. For bank holding companies the structure is less intrusive than the regulatory structure today. For others in financial services the structure is somewhat more intrusive. Yet the non-bank holding company sectors of the financial services industry accept this level of regulation as a cost of moving forward to modernize the industry.

Unlike years past, when legislative efforts deadlocked due to inter-industry turf fights aimed at forestalling competition, there is no disagreement in the industry about the basic structure of H.R. 10. Faced with the realities of already integrated domestic markets and increased global competition, the acceptance -- both within government and industry -- of affiliations between the three pillars of the financial services industry with appropriate supervision removes a tremendous barrier to the enactment of meaningful reforms.

Conclusion

In concluding, I want to reiterate the urgency of enacting financial services modernization legislation. Today's mergers are a response to a rapidly evolving and demanding market. The U.S. financial services industry must be nimble enough to meet the growing demands of consumers -- individuals, businesses, and public agencies alike. Financial modernization will allow firms to better serve their domestic customers and meet international competition in an industry that is vital to the nation's future. But only with Congressional action can an even-handed and comprehensive structure for the financial services industry be achieved.

Merrill Lynch

Preserving America's Financial Competitiveness

Modernizing U.S. Financial Laws for the 21ST Century

White Paper on Financial Services Reform

January 1999

www.ml.com/financial-reform

Introduction

Fundamental reform of America's financial laws is long overdue. The product of a bygone era, these laws limit full competition, restrict consumer choice, impose unnecessary costs, dampen innovation and, ultimately, threaten America's global leadership in financial services.

Merrill Lynch believes it is time for Congress and the Administration to modernize U.S. financial regulations and introduce full and open competition across the banking, securities and insurance industries — competition that will benefit every citizen who is a consumer of financial services. A more open and competitive financial services industry will help individuals and businesses alike, providing them with greater convenience, increased innovation and lower costs, while strengthening America's competitive position in the global economy.

This is Merrill Lynch's vision, and we are convinced it is a vision that will benefit American consumers and help drive U.S. economic success into the 21st Century. Today, the 106th Congress has an historic opportunity to make this vision a reality.

H.R. 10—"An Historic Achievement"

Our nation's policy makers were more successful than ever last year in advancing financial reform.

For twenty years, Congress has tried to modernize our financial services laws. Each time territorial or industry-specific rivalries prevented passage of a bill in the U.S. House of Representatives — until 1998. In an historic vote, the House passed the Financial Services Act of 1998 (H.R. 10), which would eliminate the barriers separating commercial banking from insurance and securities activities. Federal Reserve Chairman Alan Greenspan applauded the House vote, calling it "an historic achievement."

Progress also occurred in the Senate. The Banking Committee sent a revised version of H.R. 10 to the Senate floor late in the Congressional session. Even after two overwhelming procedural votes to proceed with H.R. 10, the bill was not brought up for a floor vote and time ran out on the 105th Congress.

Last year's accomplishments lay the groundwork for passage in the new Congress. Not only would the legislation bring long overdue changes to the financial services industry, but it would also:

- Allow consumers to take care of their banking, investing and insurance needs at a single source.
- Establish sensible regulation by function that would ensure financial services firms engaged in the same activities are subject to the same set of rules.
- Eliminate the unfair competitive advantages granted to one sector over another by today's fragmented regulatory system.

Widespread Industry Support for Financial Services Reform

Merrill Lynch, along with more than fifty other financial corporations, actively supported the development and passage of H.R. 10. For the first time, financial services companies and trade associations for all sectors of the financial services industry, including banking, securities, insurances, and investment companies, have reached agreement on a common approach to financial modernization. The following financial services trade associations have pledged to work together for the enactment of reform in 1999:

- American Bankers Association
- American Council of Life Insurance
- American Insurance Association
- Financial Services Council
- Independent Insurance Agents of America
- Investment Company Institute
- Securities Industry Association
- The Bankers Roundtable

The World Created by Glass-Steagall

America's financial services companies operate under a regulatory regime that dates to the Great Depression.

The Banking Act of 1933, which included the Glass-Steagall Act, was passed in the wake of widespread bank failures. With an eye toward "safeguarding" the banking system,

the Glass-Steagall Act separated commercial banking and the taking of deposits from investment banking (i.e., the underwriting of and dealing in securities).

From the beginning, the Glass-Steagall Act was premised on questionable assumptions. More importantly, it set a misguided direction for future public policy, beginning an effort to compartmentalize financial services functions in order to control risk. Twenty-three years later, Congress expanded the banking regulatory regime established in the 1930s by passing the Bank Holding Company Act of 1956 which prohibits diverse financial services firms from being organized under a single corporate umbrella.

While these two pieces of legislation have endured for the better part of a century, America's economy and our financial system have undergone startling transformations:

- Gross Domestic Product has expanded more than 100-fold, from $56 billion in 1933 to more than $8.5 trillion today.
- International trade has reshaped the global economy, rising from 9% of GDP in the 1930s to 24% today.
- In the past ten years alone, the world's total financial assets have expanded about 11% annually, to approximately $50 trillion.
- Since 1981, the average daily volume on the New York Stock Exchange has exploded, from around 40 million to over 600 million shares traded daily.

The Faulty Theory Behind Glass-Steagall

Senator Carter Glass (D-VA), co-author of the Glass-Steagall Act, subscribed to a controversial theory of banking — the "real bills doctrine" — that restricted the operation of banks to only two purposes: taking money from depositors and lending those funds to businesses on a short-term basis. Senator Glass ridiculed securities activity as "gambling" and was convinced that banks' securities activities were responsible for the bank failures during the Great Depression. Prior to 1933, Senator Glass had tried and failed to pass legislation separating commercial and investment banking activities. The Depression provided the public outcry the Virginia senator needed to impose his worldview on the financial services industry.

Remarkably, not a single witness during Senator Glass's Subcommittee hearings endorsed his views regarding the special "risks" that securities functions allegedly posed to banks. Indeed, experts have pointed out that, "none of the witnesses identified securities activities or securities investment, whether purchased from bank securities affiliates or not, as a cause of bank failures."[1]

Why did witness after witness fail to lay blame for bank failures on securities "gambling"? Because it wasn't true. As two leading academics observed in a comprehensive study of the era, "[Prior to the Great Depression] banks engaged in securities activities had lower failure rates than otherwise similar banks." They concluded: "Throughout history, few if any U.S. commercial banks have failed because of their involvement in securities activities either before or after Glass-Steagall."[2] Indeed, other studies have shown that securities affiliates tended to reduce the likelihood of bank failures in the late 1920s and early 1930s.[3]

Ironically, two years after the Glass-Steagall Act was passed, Senator Glass himself had second thoughts: he supported a bill to weaken Glass-Steagall. It was the first of many unsuccessful attempts to repeal the Act over the next six decades.

The Expansion of "Section 20"

Section 20 is one of the major provisions of the Glass-Steagall Act, prohibiting banks from being affiliated with any other organization that is "engaged principally" in underwriting or dealing in certain securities. Initially, that restriction limited banks to underwriting and dealing only in U.S. Treasury securities and general obligation municipal bonds. Over the years, however, banks have used provisions in the law to extend further into investment banking activities. Within the last two decades, regulators and the courts have expanded the power of banks to engage in a wide variety of securities activity, including the power, under an increasingly broad interpretation of Section 20, to pursue more underwriting business.

In 1987, the Federal Reserve created the "Section 20 Affiliate," allowing banks to participate in investment banking so long as the affiliate accounted for 5% or less of gross revenues. In 1989, the "Section 20" revenue limit was raised to 10%, and in 1997 it was raised again to 25%. Today, banks have the ability to offer discount brokerage services; advise and manage mutual funds; and provide M&A advice to companies. Under the 25% revenue limit, they have the ability to acquire or build larger securities operations than ever before. Through these acquisitions, banks are now dealing in stocks and bonds and offering underwriting services that have always been regarded as the traditional activity of investment banking. For these banks — but not for securities firms — the expansion of Section 20 has virtually erased the separation of commercial and investment banking.

H.R. 10 eliminates the "one-way street" by permitting securities firms to engage in banking activities. At the same time, the legislation lifts the Section 20 cap and makes it possible for banks and their affiliates to engage in unlimited securities underwriting and sales.

"The restrictions and separations mandated by the Glass-Steagall Act ... have grown outmoded, and now hinder the ability of our markets and market participants to compete effectively. The need to modernize American financial services has become more urgent than ever before ... I view this legislation as an urgent national priority."

Arthur Levitt Chairman
Securities and Exchange Commission

Despite these sweeping changes, there has been no federal legislation aimed at creating a new and comprehensive regulatory framework for U.S. financial institutions competing in the global economy. Rules put in place 66 years ago still govern modern financial transactions.

In today's marketplace, Glass-Steagall and the Bank Holding Company Act are, simply put, anachronisms. Testifying before the House Banking and Financial Services Committee in June, 1997, Treasury Secretary Robert E. Rubin stated bluntly that American financial services are "Still operating under an outdated legal and regulatory structure."[4]

The Banking Committee Chairmen in the House and Senate both agree the time is right for reform. House Chairman, Rep. Jim Leach, said recently "there is broad agreement at this time on the terms of financial services legislation" and that financial services modernization will be his committee's "top priority."

The new Chairman of the Senate Banking Committee, Senator Phil Gramm, also intends to place financial services reform at the top of his agenda. He recently stated:

> *"The No. 1 piece of unfinished business from the last Congress — in fact, for the last 10 Congresses — is financial services modernization. I am determined to act and to act swiftly."*

Financial Services Today

Recent decades have seen a genuine revolution in financial services. In the 1930s, who would have dreamt that millions of Americans would trade stocks and bonds over the Internet? That breakthrough products would blur once easy distinctions between debt and equity? Or that mutual funds would become the saving vehicle of choice for the vast share of the American public?

Depression-era regulations have been rendered obsolete by a rush of innovation and the demand of customers for access to a fuller range of financial services. There is not a single major advance in financial services — from electronic banking and interest rate swaps to central asset accounts and Internet trading — that was anticipated by our banking laws.

The direct fallout of public-policy decisions made in the 1930s is clear. America's obsolete banking regulations constrain and divide the U.S. financial services industry at the very moment it seeks to respond to ever-accelerating changes in the marketplace. These laws have created a fragmented financial industry with only limited competition across banking, securities and insurance, while producing uneven regulatory regimes on similar products and services, handicapping U.S. institutions in the global arena and imposing costs on American consumers.

> *"The Federal Reserve has long believed that Glass-Steagall reform is urgently needed and has been recommending that Congress update the laws that structure the delivery of financial services to the American public ... The Board is concerned that in the absence of congressional action there will be continuing erosion of the supervisory framework for financial services with destabilizing and potentially damaging effects on our financial system."*
>
> Alan Greenspan, Chairman, Federal Reserve Board

Moreover, existing regulations have introduced a demonstrably uneven playing field. Most glaring is the impact of the Federal Reserve's recent expansion of the so-called "Section 20" provision. *(See inset on page 4.)* The 1997 expansion of the Section 20 revenue limit from 10% to 25% makes it far easier for a bank or bank holding company to build or purchase even a large securities firm.

Almost immediately after the Fed's change, a steady stream of highly publicized acquisitions began — first with the purchase in April 1997 of Alex, Brown, the oldest securities firm in the U.S., by the bank holding company that own Bankers Trust. In late 1998, Deutsche Bank announced plans to acquire Bankers Trust, resulting in the world's largest banking organization. Since then, the marketplace has seen frequent announcements of bank acquisitions of securities firms. *(See inset on page 7.)*

In principle, global consolidation in the financial services industry is welcome news. It will serve the best interests of consumers and financial services companies alike. And the U.S. securities industry should be vying for a central role in

this consolidated marketplace. After all, American securities firms are global leaders, with the top three U.S. securities firms annually accounting for nearly 30 % of all debt and equity securities underwritten in the U.S. and cross-border markets worldwide.

Yet the existing U.S. regulatory framework threatens the continued preeminence of American financial services firms. The expansion of Section 20 has effectively created a one-way street in the U.S. financial services marketplace, where U.S. and non-U.S. commercial banks can move aggressively into the securities business, while securities firms cannot build or acquire full-fledged commercial banks.

This change has also increased the possibility that U.S. securities firms could be acquired by institutions headquartered outside the U.S.

A More Competitive Financial Services Industry

Merrill Lynch is a global company that embraces open markets and free competition and rejects protectionism anywhere in the world.

In calling for the modernization of our financial services laws, we seek a truly open and competitive U.S. financial industry — one that can offer lower prices and superior service to customers, bring unprecedented innovation and convenience to the market and allow U.S. firms to compete effectively with non-U.S. institutions in world markets.

For American consumers, the advantages of a modernized financial services industry can be quantified. The Bureau of Economic Analysis estimates that in 1995, American consumers spent nearly $300 billion on fees and commissions for brokerage, insurance and banking services. If the transaction costs that companies now incur were added, the figure might double. In his June 1997 testimony before Congress, Treasury Secretary Rubin speculated about the potential savings that would accrue from a modernized regulatory system, saying:

> *"[I]t's not unreasonable to expect ultimate savings to consumers of 5 % from increased competition in the securities, banking and insurance industries — as much as $15 billion per year. These savings would be substantially greater if you include costs to companies, as well as consumers."*

Small Banks Continue to Thrive

It is a common misperception that consolidation in financial services is unwelcome news for small, local banks. Yet there is virtually no evidence to support this view. A recent study by the Dallas Federal Reserve found that "banks of many sizes and types are competitively viable ... ongoing consolidation in the banking industry will not harm and may improve overall profit efficiency."[5]

Recent experience bears this fact out. In 1994, Congress passed the Riegle-Neal Interstate Banking and Branching Act, which allowed banks to merge over state lines. The new law created a surge in interstate banking, but predictions that it would be the end of local banking never materialized. Indeed, in 1995, the year following the legislation, charters for new banks increased by 300 %.[6]

Small businesses have also benefited from these developments. According to a 1996 Federal Reserve Bank of New York study, newly merged banks that resulted from the new interstate banking law actually increased their lending to small business. Federal Deposit Insurance Corp. data tells us that from 1994 to 1996, there was a 10.3 % increase in the total value of loans to small business.[7]

Selected Acquisitions of U.S. Securities Firms by Commercial Banks, 1997–98

The patchwork of antiquated laws has enabled a remarkable number of banking organizations "both domestic and foreign" to acquire leading U.S. investment banking firms. It has also led to some unusual entries into the U.S. financial services industry.

In 1997, Bankers Trust acquired the nation's oldest brokerage firm, Alex Brown, only to now be in the midst of being acquired itself by Deutsche Bank. Dillon Read has been taken over by SwissBank Corp. and Oppenheimer & Co. is now part of a Canadian bank securities subsidiary which underwrites corporate debt and equities.

Note that there have been no acquisitions of banks by investment firms. The reason is that bank holding companies and foreign banking firms are able to fit within the expanded Section 20 revenue restrictions that have been established by the Fed. As a result, some 35 securities firms have been acquired in the past two years.

Securities firms and insurance companies are unable to take advantage of Section 20 and acquire a full commercial bank without totally restructuring into bank holding companies and divesting certain activities.

Alternatively, financial services and other companies have turned to other avenues, primarily the thrift charter.
Along with numerous securities firms and insurers, a host of diverse enterprises are seeking thrift charters including Ford, General Motors, American Express, Farm Bureau, Hillenbrand Industries, UKROP's Super Markets, Nordstrom, and National Association of Mutual Insurance Companies.

Other notable acquisitions include the following:

Commercial Bank	Acquired Securities Firm
ABN AMRO	Chicago Corp.
BankAtlantic Bancorp	Ryan Beck & Co.
BankBoston	Robertson, Stephens & Co.
Bank of New York	ESI Securities Co.
Bank of New York	Mendham Capital Group
Bankers Trust*	Alex, Brown and Sons
BB&T Corp.	Scott & Stringfellow Financial
Canadian Imperial Bank of Commerce	Oppenheimer & Co.
Citicorp	Travelers/Salomon Smith Barney
Fifth Third Bancorp	Ohio Co.
First Chicago Corp.	Roney & Co.
First Union	Wheat First Butcher Singer
First Union	Bowles Hollowell Conner & Co.
Fleet Financial	Quick & Reilly
ING Barings	Furman, Selz
Key Corp.	McDonald & Company Investments
Mellon Bank Corp.	Pacific Brokerage Services Inc.
NationsBank*	Montgomery Securities
SunTrust	Equitable Securities Corporation
Societe Generale	Cowen & Co.
SwissBank Corp.	Dillon, Read
Toronto Dominion Bank	Kennedy, Cabot & Co.
US Bancorp	Piper Jaffray Cos.
Wachovia	Interstate/Johnson Lane

* BankAmerica and Nations Bank merged in 1998.
Bankers Trust has agreed to be acquired by Deutsche Bank

Broad Public Support

Financial services reform may not be a topic of conversation at the average dinner table, but the issues at stake clearly resonate with the American public. A June 1998 survey conducted by the Tarrance Group Inc. and commissioned by Merrill Lynch found that by a margin of 51% to 32%, American voters overwhelmingly favor regulatory reform of U.S. financial services laws that would allow banks, insurance companies and securities firms to enter each other's businesses and offer clients the full range of financial services and products.

When questioned about the importance of several issues surrounding financial services modernization, vast majorities of American voters view the potential benefits as "extremely important" or "very important." For example:

- **73% believe that ensuring "American financial institutions remain number one in the world" is either "extremely" or "very" important.**
- **66% believe that allowing "greater competition in the financial services industry in order to bring about better prices for clients and consumers" is either "extremely" or "very" important.**
- **62% believe that modernizing "financial services [laws] that were written in the Depression era ... as we enter the next century" is either "extremely" or "very" important.**

Financial modernization should enable small businesses, particularly those in rural America, to have better access to capital. This was confirmed by a recent study conducted at St. John's University that argues that 'modernization of financial services regulation affects the banking industry, allowing large and small institutions to compete more freely and provide a greater range of services. Currently discussed legislative proposals would permit banks to offer securities, investment, mutual fund, and insurance type products, in addition to banking products.'[8] Once the barriers to financial services affiliations are removed, small banks will be in a position to offer more services in rural areas giving small businesses a broader range of capital sources from which to choose.

The Principles of Reform

The challenge now before Congress is to establish a framework for making modernization of the financial services industry a reality and delivering the benefits of reform to American consumers. Merrill Lynch believes that such a framework should be based on the following principles:

- **Congressional Action.** Congress, not regulators or the courts, should enact comprehensive financial services reform to best service American savers and investors and our nation's capital-raising activities.
- **No Barriers, No Advantages.** Congress should act to establish a level playing field by providing for free and open competition for all financial services providers. The new financial services holding company structure should not include barriers that favor one industry over another.
- **Two-Way Street.** Banking organizations should be allowed to own securities firms and insurance companies, and securities firms and insurance companies should be permitted to own or affiliate with banks

- **Functional Regulation.** Regardless of the owner, the separate segments, subsidiaries and affiliates of a financial services holding company should be regulated along functional business, product and service lines.

- **Holding Company Oversight.** Holding company regulations should center on oversight, not regulation. These regulations should be designed to achieve legitimate public policy goals, not to preserve regulatory standings of the past or prevent a company in one industry from competing against one in another.

- **Proper Use of Insured Deposits.** Safeguards must be adopted that prevent the use of insured deposits from being used to "bail out" affiliates that are not depository institutions.

Congress Must Act

Comprehensive reform embracing these principles is the best way to ensure the continued vitality of the U.S. financial markets, deliver benefits to American consumers and preserve our nation's leadership role in worldwide financial services. For this vision to become a reality, however, Congress must reassert its leadership over our country's financial services laws.

For years, this power has been ceded to bank regulators and the courts, both of which have implemented piecemeal changes to America's financial laws without taking into consideration an overall strategic vision for the industry. Over the last decade, Congress has tried and failed five times to enact comprehensive financial industry regulatory reform: in 1986, 1988, 1991, 1995–96 and 1997–98. Today, with a whirlwind of global financial industry consolidation underway, the 106th Congress has an historic opportunity to succeed where others have failed, freeing the U.S. financial sector from a network of rules that belong to an earlier era.

With the passage of H.R. 10 in the House and near passage in the Senate, we believe there is an unprecedented legislative opportunity for fundamental reform and modernization of the financial services industry. The framework for financial services is undergoing rapid change around the world with dramatic restructuring of financial markets in Europe and Asia increasing the pressing need for the U.S. to modernize its laws so it can retain its competitive edge in financial services. Further delay until some future time simply opens the possibility that U.S. firms will slip behind our global competitors.

Merrill Lynch believes that financial services modernization is the single most important economic issue now under consideration in Washington. We stand ready to work with Congress and the Administration to craft and support legislation that will truly benefit all Americans.

Frequently asked questions about modernizing America's financial laws

Q: What is the Glass-Steagall Act?

A: America's financial services companies operate under a regulatory system that dates back to the Great Depression. The Glass-Steagall Act was one of the main elements of the Banking Act of 1933. Essentially, it separated commercial banking and the taking of deposits from investment banking (i.e., the underwriting of securities).

Q: What is the significance of the Bank Holding Company Act?

A: The other major element of U.S. financial law is the Bank Holding Company Act. Originally passed in 1956 and amended subsequently, this Act restricts who can control a commercial bank and generally prohibits companies that control a bank from engaging in non-banking activities, either directly or indirectly. The Bank Holding Company Act prevents a diversified financial services holding company from being organized under a single corporate umbrella and keeps other financial services sectors from expanding into commercial banking.

Q: Why are these laws in need of reform?

A: Together, the Glass-Steagall Act and the Bank Holding Company Act severely limit the ability of banks, securities firms and insurance companies to provide their clients with the full range of financial services they desire. These restrictions serve neither consumers nor financial institutions, and they are badly outdated. The U.S. economy and the financial services industry have changed tremendously in the decades since these laws were introduced. There is not a single major innovation in financial services — from central asset accounts to securitization to interest rate swaps to electronic banking — that was anticipated by our banking laws.

Q: Why is there currently an uneven playing field in financial services and what risk does this present?

A: Over the years, piecemeal changes by the courts and regulators have enabled commercial banks and their affiliates to overcome the Glass-Steagall barrier and become active in various aspects of the securities industry. Recently, these changes have tilted the playing field toward the commercial banking sector, since they have enabled banks to enter the securities business far more extensively while securities firms continue to be prevented from entering full commercial banking.

Q: Exactly what changes have the regulators recently introduced?

A: In early 1997, actions by the Federal Reserve dramatically increased the ability of commercial banks to engage in securities activities. The Fed did this by more than doubling the limit on the amount of revenue banks could derive from their "Section 20 Affiliates" (i.e., affiliates authorized to deal in securities). With the revenue limits in place today, banks can now either build much larger securities businesses or acquire even large securities firms — as illustrated by a series of acquisitions since the expansion of Section 20.

Q: What risk does this uneven playing field present?

A: The current environment limits the ability of securities firms to compete with commercial banks — both foreign and domestic — in the U.S. At this time of global consolidation in financial services, it is particularly unfair for securities firms to remain bound by outdated laws. The current regulatory environment also creates a unique opportunity for firms headquartered outside the U.S. to acquire large parts of the U.S. securities industry — a situation that threatens U.S. leadership in the global capital markets.

Q: What changes in financial services law does Merrill Lynch support?

A: It is time for legislation that provides fair and open competition between all financial service providers and keeps the U.S. capital markets open, free, and competitive. We believe a "two-way street" is needed in order to give investment banks the same opportunity to compete as commercial banks now enjoy. In our view, Congress — not the regulators nor the courts — should modernize America's financial services laws to create a system that will give consumers more choices and allow American firms to remain leading players globally.

Q: What would be the benefits of a system of this type?

A: A financial services industry with open competition and a level playing field will benefit all consumers of financial services, providing them with competitive pricing for products and services, greater innovation in new products and new services and greater convenience. Modernizing America's financial industry regulations will create a stronger U.S. financial services sector, prepared to compete globally in the 21st Century.

Right now, Germany, Switzerland and other European countries have "universal banking" that integrates commercial banking services with investment banking. Since 1992, Japanese financial companies have also been permitted to offer a full range of banking services. Until U.S. financial regulations are modernized, American firms will continue to operate under significant handicaps that hamper our ability to compete in international capital markets.

Q: What are the concerns over the mixing of commerce and banking?

A: There are really two issues involved: first, commerce owning banking; and, second, financial services holding companies, which may include a bank, investing in non-financial companies. On the first issue, Congress will no doubt limit the ownership of banks by commercial companies — a practice not allowed in most industrialized countries.

With respect to investments by financial services companies in commercial enterprises, these combinations have long been part of the normal course of business for financial institutions in the U.S. and around the world. We believe it is important that financial services reform continue to allow financial institutions to engage in merchant banking activities and make strategic investments in areas such as telecommunications and electronic delivery systems which are important to our financial system.

Q: What impact will the pending financial services modernization legislation have on national bank charters?

A: The legislation broadens the ability of national and state chartered banks to engage in a broad range of financial services. The pending legislation allows banks to affiliate with full-service insurance companies and securities firms.

Notes

1. George J. Bentson, *The Separation of Commercial and Investment Banking The Glass-Steagall Act Revisited and Reconsidered,* Oxford University Press, 1990, p. 38.

2. George J. Bentson and George G. Kaufman, Commercial Banking and Securities Activities: A Survey of the Risks and Returns, paper prepared for the American Banking Association Securities Association, October 1995.

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4. Statement of the Honorable Robert E. Rubin, U.S. Secretary of the Treasury before the House Banking and Financial Services Committee, June 3, 1997.

5. Thomas F. Siems and Jeffrey A. Clark, "Rethinking Bank Efficiency and Regulation," Federal Reserve Bank of Dallas, December 1997.

6. John S. Barry, "Banking Deregulation Works," *Investor's Business Daily,* March 28, 1996, A2.

7. Ibid.

8. Dr. Francis A. Lees and Donald Pitti, "How Community Banks Will Benefit From Modernized Financial Services Regulation," Financial Services Institute, St. John's University, July 1998.

TESTIMONY BY

MICHAEL E. PATTERSON
VICE CHAIRMAN
J. P. MORGAN & CO. INCORPORATED

ON BEHALF OF

FINANCIAL SERVICES COUNCIL

BEFORE THE

COMMITTEE ON BANKING AND FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

FEBRUARY 10, 1999

Introduction

Mr. Chairman and Members of the Committee, I am Michael Patterson, Vice Chairman of J.P. Morgan & Co. and Chairman of the Financial Services Council. I am pleased to be here today to testify on H.R. 10, the "Financial Services Act of 1999."

The Financial Services Council differs from other associations that will come before you to discuss financial modernization because it represents the views of companies active in all sectors of the financial services industry, rather than companies that are in one specific industry sector. Our membership includes banks, securities firms, insurance companies and diversified firms that engage in both financial and nonfinancial activities. Members of the Financial Services Council compete head to head every day for the opportunity to serve consumers and investors. But we share the conviction that fundamental reform of America's financial laws is necessary to allow U.S. financial services firms to provide their customers with a full range of products, greater convenience, more innovation, and lower costs, and to enable U.S. firms to compete on fair and equal terms in domestic and international markets.

For more than a decade, it has been apparent that consumers and markets would benefit by unshackling the financial services industry from an antiquated legal structure. The provisions of the Glass-Steagall Act and the Bank Holding Company Act, some of them enacted more than 65 years ago, were designed in response to a marketplace that no longer exists. There is a consensus shared by most financial firms and their customers, as well as policymakers, that these rules restrict competition, reduce consumer choice, and

are not necessary to protect consumers or insured financial institutions. Treasury Secretary Rubin testified in 1997 about the savings to consumers that would result from reform of our depression era financial laws. He stated that "it would not be unreasonable to expect ultimate savings to consumers of 5 percent from increased competition in the securities, banking and insurance industry -- as much as $15 billion per year. These savings would be substantially greater if you include costs to companies, as well as consumers."

This Congress has a unique window of opportunity to pass major financial reform this year, and we think it imperative that you do so. Unlike years past, when we urged financial reform on the basis of predictions of rapid changes in the financial markets, you are now addressing this legislation in the context of accelerating global financial industry consolidation. Over the past year, we have witnessed our international competitors both consolidate their resources and acquire a number of American financial institutions. Despite the consolidation that also is occurring in the U.S., most of the largest and most diversified financial services companies today are still headquartered outside this country. We must not allow obsolete laws to inhibit the global preeminence of U.S.-based financial corporations and of our nation's financial markets.

The rapid evolution and convergence of banking, securities and insurance will not cease; and it is important that the Congress act to establish a regulatory framework that enables American firms to respond efficiently and effectively to the imperatives of the marketplace, while providing for appropriate supervision of large and complex institutions.

Should Congress fail to act, the restructuring of the global financial industry will simply proceed while American institutions remain handicapped by antiquated laws.

The goal should be to enhance the global competitiveness of American firms, while advancing competition and consumer choice here at home. H.R.10 does much to achieve this balance, strengthening our ability to compete with foreign financial institutions here and abroad and granting new competitive opportunities to financial companies here at home. The ultimate beneficiaries of this increased competition are consumers, who will have more convenient access to a greater number of products and services at lower prices.

Much of the industry infighting that has plagued the debate on this legislation is resolved. As was illustrated by consideration of H.R. 10 last year on the House floor, there is broad support for the fundamental principle behind this bill - - that banks and securities firms and insurance firms should be allowed to affiliate. Though some disagreement on regulation of financial holding companies remains, the issues are not many and can be resolved. Now is the time to put in place a workable system that will set the framework for the delivery of financial services in the new century.

Glass-Steagall and the Bank Holding Company Act

Our current financial laws were shaped in an economic era vastly different from today's. Some resulted from a misguided attempt to remedy the ills that led to the Great Depression. Others were enacted in the years that followed. Virtually all of the laws governing our financial structure were established long before the development of technology, financial products and capital markets that prevail today. While consumer

needs and the marketplace have changed dramatically, our laws remain unchanged. The central component of financial modernization is the repeal of sections of the Glass-Steagall and Bank Holding Company Acts that serve artificially to separate our financial services industry into distinct sectors.

Glass-Steagall and Section 20 Affiliates

The Glass-Steagall Act was enacted in the wake of the stock market collapse of 1929 and deep distrust of our financial sector. Glass-Steagall generally prohibits banks from underwriting or dealing in securities and from affiliating with firms that are "engaged principally" in those activities.

Glass-Steagall never completely separated banks from the securities business. For example, it permitted banks to underwrite and deal in U.S. government bonds and municipal general obligation bonds. Twelve years ago, banks were authorized to establish affiliates – known as Section 20 subsidiaries – to engage in securities activities that were ineligible to be conducted directly by a bank, for example the underwriting of corporate securities. Today, Section 20 affiliates of bank holding companies may derive up to 25% of their gross revenues from bank-ineligible underwriting activities, and some of the leading underwriters are now bank affiliates. There have been numerous acquisitions of American broker-dealers by banks in recent years. At the same time, several securities firms have established banking operations through grandfathered limited purpose banks (CEBA banks) and some have, or recently have applied for, federal thrift charters.

<u>**Bank Holding Company Act**</u>

The Bank Holding Company Act of 1956 is the other major law governing the structure of our financial services system. The Act, among other things, allows companies that control banks to engage *only* in activities that are "closely related to banking." Thus, companies that are engaged in commerce -- i.e., activities that are *not* closely related to banking -- are not permitted to own banks. The Act specifically provides that insurance underwriting is not closely related to banking. In reality, however, the barrier between banking and other financial and nonfinancial activities has never been airtight. For example, individual persons are allowed to own banks and commercial businesses. Thus, an individual that owns a bank can also own a car dealership or a shoestore. Insured financial institutions that are not "banks" under the Act, such as thrifts, credit card banks, industrial loan companies and CEBA banks, may be owned by companies that engage in commercial activities without limit. In fact, until 1970 commercial businesses could own full-service banks as "one bank holding companies," just as they may today be a unitary thrift holding company.

Just as non-banking financial firms and some commercial companies have found ways to get into the banking business, bank regulators have allowed banks, in accordance with current laws, to expand their insurance activities – principally through retail sales. Increasingly, financial services are converging and providers compete across traditional industry lines. But true competition is limited by law.

Changing Marketplace

Two factors are driving these market developments -- technological advances and the needs of wholesale and retail customers. The current regulatory structure was put in place when the range of services available to the consumer, as well as the number of potential providers, was limited. Most financial services were obtained locally, more often than not from a neighborhood banker or insurance agent with whom the consumer was personally acquainted.

In today's marketplace, consumers, investors and businesses are not hesitant to obtain services from a variety of providers, some locally, and some located in distant places. While many consumers still choose to obtain services from a local source with whom they are personally acquainted, others prefer the convenience of transacting business over the telephone or via the Internet. Consumers not only have access to financial information 24 hours a day, but they can initiate financial transactions worldwide on a real-time basis.

Consumer needs have prompted the development of financial services that were unknown or only available on a limited basis not long ago -- services like mutual funds, money market accounts, credit cards, various types of mortgages, individual retirement accounts, home equity loans, stored value cards, and a variety of products geared to the business owner. Many of these new products are the result of an increasing level of competition by financial services providers across industry lines, providing alternatives to their common customers for services once available only from a single source. For example, money market mutual funds were developed to provide an investment alternative

for funds that consumers were holding in bank accounts. Banks provide loan syndications and private placements to investors that are in economic substance equivalent to bonds underwritten by securities firms. Life insurance companies developed single premium annuities to compete with bank certificates of deposits.

Delivery of these products is facilitated by increasingly sophisticated communications and information technology, which enable financial firms to handle information more efficiently and to develop improved products geared to the needs of each individual consumer and investor. Transaction costs and processing time are declining, while financial services providers are better able to access information about a customer's total account relationship in order to offer products best suited to the customer's needs.

But while technology and competition have offered the potential of better products and services, increased efficiency, and lower costs, the extent to which U.S. financial institutions can take advantage of these opportunities has been limited by statutory and regulatory constraints. For financial services firms to function efficiently in today's complex global economy, our financial services laws must be revised to accommodate the changes in consumer and business demands and their savings, investment, and capital-raising preferences. A new legal framework must recognize that the old segmentations of financial services providers no longer make sense, that financial services products now compete across traditional industry lines, and that communications and technology ensure that changes in financial services will continue to occur. It is imperative that this structure

be flexible enough to accommodate future market developments without building unnecessary barriers to competition.

Pending Legislation

H.R. 10 offers a solid foundation for reform. It addresses the issues surrounding the market driven integration of financial services. It allows for full affiliation of financial services -- banking, securities and insurance -- under one holding company. It would allow a bank holding company to bring a new product to market or engage in many new activities without the current cumbersome and time-consuming application process. The bill establishes the structure for functional regulation, while maintaining the Federal Reserve oversight of the holding company as a whole.

Unlike years past, when legislative efforts deadlocked due to inter-industry turf fights aimed at forestalling new competition, there is today less disagreement in the industry about the basic structure of H.R. 10. Faced with the realities of rapid convergence of financial services and increased global competition, the acceptance by both government and industry of affiliations among the three main pillars of the financial services industry, with appropriate supervision, removes a long-standing barrier to the enactment of meaningful reforms.

The outstanding issues in H.R. 10 that I will comment on are limited to three general areas: (1) the regulatory role of the Federal Reserve; (2) whether activities not eligible for a bank may be conducted in an operating subsidiary of a bank, as well as in an

affiliate under a holding company; and (3) the need for flexibility in the definition of what is "financial in nature".

<u>Role of the Federal Reserve</u>

Regulatory Oversight

Under H.R. 10, "financial holding companies" (FHCs) are subject to oversight by the Federal Reserve Board for a variety of purposes. These include a determination of whether the company qualifies to operate as a financial holding company and continues to meet those requirements over time (e.g., whether the activities of holding company affiliates are restricted to those that are "financial in nature"), whether the activities of a holding company and its operating subsidiaries represent a risk to the deposit insurance or payments systems, and whether holding company mergers or acquisitions would produce public benefits. By expanding both the activities permissible for financial holding companies and the number of financial services firms subject to the Board's oversight, the legislation significantly expands the Board's role with respect to a growing and diverse sector of the economy. It is therefore important that the Board's authority be clearly delineated, focused on issues in which it has expertise, and crafted to avoid unnecessary impediments to the ability of financial firms to compete both domestically and in global markets.

Prior Notice of "Large Combinations"

H.R. 10 requires an application to the Federal Reserve Board for "large" (over $40 billion combined total assets) acquisitions of non-banks and authorizes the board to

disapprove the combination if it does not meet certain broad conditions whether the combination would "produce benefits to the public" or would represent an "undue concentration of resources". These provisions, which were not in the version of H.R. 10 passed by the House last year, are unnecessary and could delay or affect the market value of proposed transactions, and would require the Board to make determinations with respect to non-banks that do not bear directly on financial considerations within its expertise. Federal Reserve Chairman Alan Greenspan has testified that the Federal Reserve does not need or want to maintain any application process for approved activities not involving a bank acquisition. Accordingly, we believe these requirements should be removed from the bill. At most the Boards's role should be limited to the provision of information bearing on antitrust implications to the Justice Department.

Operating Subsidiaries

H.R. 10 would prohibit bank operating subsidiaries from engaging in all non-agency activities that are not permissible for a national bank to engage in directly. This position, which is supported by the Federal Reserve, has been an anathema to the Treasury Department. The issue could be resolved on terms that would seem to be generally acceptable to most financial firms by adopting the compromise operating subsidiary language that was passed by the House Banking Committee last year (allowing bank subsidiaries to engage in financial activities other than insurance underwriting and merchant banking). However, this issue has become philosophical battleground between two key bank regulators. Given the great progress made on all other fronts, this dispute

should not be allowed to stand in the way of financial modernization. In general, a heavy burden of persuasion should accompany advocacy of regulatory limitations on the flexibility of financial services providers to organize themselves in a manner best suited to serve their customers and for their maximum efficiency. We do not believe that a compelling case has been made for the current prohibition of H.R. 10.

Financial in Nature and De Minimis Non-Financial Activities

The Financial Services Council has long held the view that it is unnecessary to maintain the partial separation of banking and commerce that exists today. However, in the context of H.R. 10 the issue is a narrower one -- whether financial holding companies should be allowed to conduct de minimis non-financial activities. We believe that they should.

H.R. 10 limits the activities of financial holding companies to those that are "financial in nature." It provides a list of activities that are deemed to be "financial" and a procedure for that list to be expanded, within limits, by the Federal Reserve Board. We believe, that some additional flexibility should be built into this definition in order to avoid excluding from bank ownership financial firms that engage to a limited extent in activities that might be considered non-financial.

First, it would be advantageous to remove the delays and uncertainties created by the need to seek regulatory interpretations of the permissible activities list, by expanding the list of activities that "shall be considered" to be financial to include those currently listed in subsection (c)(4) (i.e., management of financial assets other than money or

securities, transferring financial assets, and engaging in transactions for the account of third parties). These activities were originally included in the list of activities that "shall be considered" to be financial when H.R. 10 was reported out of the House Banking Committee during the last Congress.

Additionally, we suggest that the definition of permitted activities should include those that are "complementary" to financial activities, as well as any other service which the Federal Reserve Board has determined not to pose a substantial risk to the safety or soundness of depository institutions or the financial system generally.

The world of finance has changed. Information services and technological delivery systems have become an integral part of the financial services business. Financial firms use overcapacity in their back office operations by offering services to others such as telephone help lines or data processing for commercial firms. These activities may not be strictly "financial," yet they utilize a financial firm's resources and complement its financial capabilities in a manner that is beneficial to the firm without adverse policy implications.

Financial firms also engage in activities that arguably might be considered non-financial, but which enhance their ability to sell financial products. One example is American Express, which publishes magazines of interest to its cardholders – *Food & Wine* and *Travel & Leisure*. *Travel & Leisure* magazine is complementary to the travel business (an activity permitted within the definition of financial in H.R. 10) in that it gives customers travel ideas which the company hopes will lead to ticket purchases and other travel arrangements through American Express Travel Services. Similarly, *Food & Wine* promotes dining out, as well as purchases of food and wine, all of which might lead to

greater use of the American Express Card. These activities are complementary to financial business and thus should be permissible for financial holding companies.

Financial firms that are not bank holding companies engage in a broad range of limited commercial activities. It makes sense for them to do so today and likely will in the future as well. We believe that financial modernization legislation should give financial firms the greatest possible latitude to make business judgements about the activities in which they engage. Their choices should be limited only when there is a compelling reason for doing so, and they must have the flexibility to accommodate innovations and products created and demanded by the marketplace. Both businesses and consumers are ultimately hurt by legislation that unnecessarily limits consumer choice and places restrictions on how companies use their capital.

Conclusion

In concluding, I want to reiterate the urgency of sound financial services modernization legislation. The House passed a financial modernization bill for the very first time last year. This year you have an historic opportunity to pass that legislation again and see it be enacted into law.

In this rapidly evolving and competitive market, the U.S. financial services industry must be nimble enough to meet the growing demands of consumers -- individuals, businesses, and public agencies alike. Financial modernization will allow firms to better serve their domestic customers and meet international competition in an industry that is

vital to the nation's future. But only with Congressional action can an evenhanded and comprehensive structure for the financial services industry be achieved.

Thank you Chairman Leach for your perseverance on this issue and for the opportunity to testify before the Committee today.

TESTIMONY BY

JOHN B. McCOY
PRESIDENT AND CHIEF EXECUTIVE OFFICER
BANK ONE CORPORATION

BEFORE THE

COMMITTEE ON BANKING AND FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

FEBRUARY 10, 1999

Good morning Chairman Leach, Congressman LaFalce and members of the Committee. I'm John McCoy, President and CEO of BANK ONE CORPORATION.

We at BANK ONE are extraordinarily pleased that the House Banking Committee is taking up H.R. 10 so early in the 106th Congress, and we pledge our continued support for financial services reform. We believe that this legislation accomplishes many critical and necessary objectives for this country's financial services industries relative to the international markets. H.R. 10 also levels the competitive playing field for insurance companies, securities firms and banks inside our national borders.

Since this committee last took up H.R. 10, tremendous changes have occurred in the marketplace. CitiGroup was created, Deutsche Bank has agreed to acquire Bankers Trust, a slew of new thrift and bank charters have been granted by the OTS and the OCC, and BANK ONE has doubled in size. The accelerated pace at which the financial services industry here and abroad is consolidating is mind-numbing.

This strong rush of affiliation among financial services companies demonstrates this Congress' immediate need to act. If not, the Congress and many U.S. institutions are going to be left behind. We know that the marketplace waits for no one and we applaud your understanding and appreciation of the big picture at stake here.

As most members know, BANK ONE played an active role in the negotiations which created the Chairman's mark up vehicle that you have before you. During the last Congress we worked closely with this committee, the House Commerce Committee and the Senate Banking Committee to assist in working through the many compromises required among the competing interests in the financial services industry to make H.R. 10 a reality. We believe that the product you have before you enjoys the support of most banks, insurance companies and agents and securities firms. Some of this support has been provided reluctantly as negotiations among these traditionally warring industries were not easy. Never-the-less, as you will learn over these next three days, H.R. 10 has broad based U.S. business support, including the three industries most directly impacted.

At least four issues, however, remain very contentious. I want to take this opportunity to review them with you and give you some insight as to BANK ONE's positions regarding each issue.

1. Bank Operating Subsidiary Powers

BANK ONE finds both the complementary and competing natures of the relationship between its two primary regulators, the Federal Reserve Board and the OCC, to be healthy and beneficial to bank holding companies, and the national bank charter. We believe that this "check and balance" relationship provides the flexibility required to successfully move U.S. financial services firms into the next millennium.

The bill you have before you restricts bank operating subsidiaries to engaging only in (1) any activity permitted for national banks themselves or (2) any agency activity authorized for a financial services holding company. The Chairman of the Federal Reserve and the Secretary of the Treasury have and, undoubtedly, will continue to debate whether or not these restrictions are appropriate.

BANK ONE's position is that national banks can and will effectively accommodate whatever resolution to this debate prevails. However, we do not believe that this issue is of a magnitude that sh ld stop H.R. 10 from moving forward. BANK ONE strongly believes that before the operating subsidiary issue is permitted to derail or destroy H.R. 10, this Congress should respectfully adopt King Solomon's judgment and offer to "split the baby" and lay the issue to rest.

2. The Community Reinvestment Act

As the 105th Congress was brought to a close, H.R. 10 failed to reach the Senate floor primarily, we believe, because of differences of opinion as to the bill's impact on CRA. Frankly, we believe that were this committee to take the pulse of the 535 members of Congress regarding CRA, you'd probably encounter 535 different opinions as to how it should be reformed.

BANK ONE is, we believe, working effectively and successfully with CRA. CRA's bottom line objective is BANK ONE's bottom line objective: use

bank products and services to strengthen communities and families across all of this country's diverse demographic groups.

How banks' bonafide business objectives and the Community Reinvestment Act and related regulations intersect is the topic of much debate. So much debate, involving so many policies, procedures and interested parties, that we do not believe the issues can be adequately addressed in anything other than a stand-alone bill.

BANK ONE does not oppose CRA nor do we have any blockbuster ideas as to how it could be made more compatible with the will of the Congress. We are, however, ready and willing to work with you to reform what began as a very short and simple bill passed in 1977 and now has become a myriad of competing concepts and regulations both inside and outside the Congress. We think, however, that this debate should take place separately from H.R. 10.

3. Mixing of Banking and Commerce

Under current law, insurance companies, securities firms mutual fund companies and some thrifts may affiliate with commercial firms. Only banks must remain separated from commercial endeavors. BANK ONE realizes that many members of Congress, including and most importantly this committee's esteemed Chair, are fearful that the mixing of banking and commerce would result in an unacceptable concentration of power on Main Street and Wall Street.

However, BANK ONE does not interpret the economic history of this country (and the experience of foreign firms currently engaged in both banking and commerce) in the same way. We believe that, regardless of lines heretofore drawn by Congress, the distinctions between financial services and commerce grow fuzzier every day, particularly in the area of electronic commerce.

We are confident that the proposals that Congress has considered to mix banking and commerce could be safely and soundly executed by this nation's financial service companies and commercial firms. We are equally confident that such affiliations can be safely and soundly regulated by this nation's regulators,

without risking the creation of oppressive concentrations of power that some members of Congress fear.

~~We understand that informed, honorable people and institutions are of different minds on this issue. We also understand that change usually comes in inches, not yards.~~ We respectfully request that H.R. 10 include an opportunity for this Congress and the banking system to gain some actual experience and empirical evidence with the mixing of banking and commerce. We believe that this experience will not be as positive as some project nor as negative as some fear.

4. Consumer Privacy

Comprehensive consumer privacy provisions are not and should not be included in H.R. 10. Very few people understand the depth and breadth of the issues inherent in this topic, or the potential consequences of any government action for consumers, banks and the entire national and international economy.

Let me also add that, unlike other industries, banks and other financial institutions are already subject to extensive privacy regulation. In the last thirty years, Congress has mandated our compliance with a web of privacy laws that create real protection for customers, including the following:

- We are required by the Fair Credit Reporting Act--which Congress recently overhauled--to abide by strict rules governing the sharing of information obtained from customers in the credit-granting process.

- We are required by the Electronic Fund Transfers Act to disclose to customers our policies for sharing information about their accounts with third parties.

- We are required by the Federal Trade Commission Act to abide by the terms of privacy policies we adopt for customers--and BANK ONE, like most banks, has in place a privacy policy.

Having said all this, I confess to you that although I actively seek more and better information every day, I remain overwhelmed by all that I don't appreciate about what might constitute appropriate and desirable consumer privacy policies. Part of the problem is that consumer privacy is an intensely personal matter and one that may be changing as technology evolves. One thing that cannot change is the foundation of trust upon which the financial services industry is built. Were we to lose that trust, BANK ONE could not exist. For this reason, we recently appointed a Senior Vice President to focus only on the privacy needs and expectations of our customers. This office will also compare our practices against those of other financial firms, as well as other service providers, such as telecommunications and retail firms.

In focusing on the consumer privacy issue, it is important to remember that the effective use of consumer data is not unique to financial services companies; it is an essential element of the business of successful companies throughout our economy that are seeking betterproducts and services for their customers.

BANK ONE believes we can learn from the many proposals beingdeliberated by various Congressional committees, business committees and alliances, consumer groups and the international economic community. We don't have the answers yet. And, like the Administration, we are fearful that restrictive government action will cripple the emergence and growth of new technologies, internet commerce and new consumer products and services.

Given the embryonic stage of these privacy issues, we implore the Congress to move at a slow and deliberate pace, seeking a full understanding of the implications of any action before it is taken.

BANK ONE does not believe that issues such as consumer privacy which have such enormous consequences on national and international trade and commerce, as well as for tens of millions of consumers throughout our nation, can be dealt with adequately as a side bar to financial services restructuring.

Again, thank you Mr. Chairman, Mr. LaFalce and the members of the committee for moving so persistently and aggressively for financial services reform. BANK ONE is committed to working with you in passing HR 10 this year.

I look forward to answering any questions.

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**STATEMENT OF
RICHARD L. HUBER
CHAIRMAN, PRESIDENT AND CEO, AETNA INC.
BEFORE THE
COMMITTEE ON BANKING AND FINANCIAL SERVICES
FEBRUARY 10, 1999**

Mr. Chairman and members of the Committee, I am Richard Huber, Chairman, President and CEO of Aetna Inc. I am pleased to testify before this Committee and share with you my perspective on financial services modernization based both on my experience in the insurance industry and also from 29 years in international banking.

Mr. Chairman, I applaud your tireless efforts and that of your colleagues who have kept financial modernization legislation moving forward. The delicate balance of differing interests you achieved last year was impressive and the hard work of your Committee has provided a solid legislative foundation for moving forward in the 106th Congress.

I am confident that all of us on this panel agree that the legal and regulatory structures under which we compete – and aggressively compete – are outdated and fraught with exceptions. I am just as confident

that we would all agree that marketplace pressures and varying interpretations of law by regulators and the courts have intensified competition. I think we all agree as well that consolidation of firms and expansion of product offerings, both domestically and abroad, will continue to take place.

The reality is financial services modernization may occur de facto. However, if this is to happen correctly and within a rational framework, you will once again have to tackle financial services modernization. Action is critical; the rapid evolution of banking, securities and insurance will not cease, and as I said, modernization will happen with or without legislation. Restructuring of the global financial industry will continue, and unfortunately if Congress cannot pass meaningful reform, American institutions will remain handicapped by antiquated laws. I personally have been involved in advocating financial services modernization for almost 20 years, and I must admit that there have been times when I doubted that Congress would find the courage to act within my lifetime!

Last Congress you achieved what many observers thought to be impossible. For more than a decade, we and others in the industry argued that consumers and markets would benefit by unshackling the financial services industry from its 60 year-old legal structure. But as you well know and to be completely honest, the internecine warfare within the financial services sector was just as vociferous.

This Committee and the 105th Congress successfully negotiated a cease-fire within the financial services sector. You developed a legislative package that allowed each industry to put aside parochial differences and find common ground. That common ground can't be lost as you move forward. H.R. 10 achieved a tricky balance in reforming the regulatory framework by enhancing our competitive position abroad while at the same time advancing domestic competition. The insurance industry supported H.R. 10 because it embodied our main goal making certain that banks entering insurance business be subject to the same statutes and regulations that insurers not affiliated with banks must observe. The insurance sector wants to slow the practice of Federal banking regulators granting insurance authority to banks without any of the solvency and other regulatory requirements of the state. Our goal is to level the playing field -- not seek

special exemptions or competitive advantage. Equal and functional regulation is the best guarantor of competitive equality.

H.R. 10 will assist U.S. based financial corporations in competing in an increasingly modernized and rationalized global financial services marketplace. One of Aetna's subsidiaries, Aetna International operates in 17 countries throughout Asia, Latin and South America, and central Europe selling pension, health, and life insurance products. When we enter an emerging market we typically joint venture with one of the leading domestic companies in that country, frequently a large retail oriented bank. We often find that our foreign partners are mystified by the rationale, or some have said lack of rationale, of our financial services regulatory scheme.

I want to share some of our foreign experience with you because we have seen some completely unexpected and positive outcomes, which simply would not have been possible in our current regulatory model in the US. Mexico is one of our most successful markets where we now have 16% of the privatized Social Security market; 28% of the immediate annuity market, and 29 % of the individual life market. We partnered with

Bancomer, the largest Mexican retail bank, to provide the distribution mechanism for our product. Initially we used the traditional agent distribution method. Then, in 1997 as Mexico privatized its social security system, we decided to use the bank's one thousand plus branch network to reach the largest possible share of the market. Seeing the tremendous success of this model, we set up a separately chartered insurance company (but with the same back office as our existing company) to sell inexpensive, plain vanilla life, auto and homeowners insurance through the same branch network. While we expected some draw off of our existing agent distributed business, we felt it was a worthwhile experiment.

The results are very interesting. The bank sales strategy reached an entirely new market segment; lower and lower/middle class Mexicans who were never reached by the traditional, higher cost distribution system. Now ten of thousands of Mexicans are participating in the insurance market, protecting their families from devastating catastrophic expenses, generating savings and creating retirement security options. And in little over a year our new subsidiary became the 6th largest insurance company in Mexico. This phenomenon did not occur because of significant increases in discretionary income; it happened because of a different way to

approach people about insurance. Ready access and long-standing trust of the bank are the explanations. The social impact of this is significant, as there is a significant potential of a strengthened lower-middle class in Mexico. This outcome would not have been possible in a regulatory structure similar to ours. Increased economic security is part of the outcome in Mexico and more funds channeled into productive sectors of the economy. Perhaps it could be one of the consequences of financial services modernization in this country as well. We'll leave the discussion of lessons learned in our numerous experiences in privatizing social security for another debate.

In closing, Mr. Chairman, I want to once again commend you for holding this hearing and for starting this process so quickly in the new Congress. I offer you my support and assistance in moving H.R. 10 forward and I wish you and your colleagues on the Committee the necessary diplomacy, energy, and commitment to maintain the delicate balance required to pass H.R. 10 in the 106th Congress.

TESTIMONY OF

ROY J. ZUCKERBERG
CHAIRMAN
SECURITIES INDUSTRY ASSOCIATION

BEFORE
THE COMMITTEE ON BANKING AND FINANCIAL SERVICES
UNITED STATES HOUSE OF REPRESENTATIVES

HEARINGS ON

H.R. 10, THE FINANCIAL SERVICES ACT OF 1999

FEBRUARY 10, 1999

SECURITIES INDUSTRY ASSOCIATION

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STATEMENT OF ROY J. ZUCKERBERG
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Mr. Chairman and members of the Committee, I am Roy Zuckerberg, Chairman of the Securities Industry Association ("SIA")[1] and a Limited Partner of Goldman Sachs & Co. I appreciate the opportunity to present SIA's views on H.R. 10, the *Financial Services Act of 1999*. Mr. Chairman, SIA commends you for your steadfast determination to enact desperately needed legislation to modernize the regulation of the United States financial services industry. We applaud your continuing leadership in reintroducing H.R. 10 at the earliest possible moment in this legislative session. Mr. Chairman, SIA is optimistic that this year Congress will pass, and the President will sign into law, widely supported financial services modernization legislation. We look forward to working with you and members of this Committee to achieve this result.

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[1] The Securities Industry Association brings together the shared interests of more than 775 securities firms to accomplish common goals. SIA members – including investment banks, broker-dealers, and mutual fund companies – are active in all markets and in all phases of corporate and public finance. In the U.S. SIA members collectively account for approximately 90 percent, or $100 billion, of securities firms' revenues and employ about 350,000 individuals. They manage the accounts of more than 50-million investors directly and tens of millions of investors indirectly through corporate, thrift, and pension plans. (More information about SIA is available on its home page: http://www.sia.com.)

Mr. Chairman, my message today is simple. The securities industry strongly supports financial services modernization legislation and urges this Committee, the House, and the Senate to pass it promptly. The House took an historic step last year when it passed a similar version of H.R. 10. In passing that legislation, the House faced and resolved many of the contentious issues that previously had prevented financial services modernization legislation from proceeding, and created an unprecedented opportunity for Congress to enact such legislation. We believe the opportunity created last year for passage of financial services modernization legislation still exists, and we urge the House to act swiftly to pass a bill.

The financial services industry is highly competitive and every segment of the industry has a stake in this legislation. As prior efforts to pass similar legislation have demonstrated, it would be nearly impossible to pass legislation that fully satisfies all parties. Over the years, SIA and many of its individual firms worked closely with banking and insurance trade groups and firms to develop many of the compromise positions on key provisions that are included in H.R. 10. As a result, H.R. 10 enjoyed the unified support of the securities and insurance industries and a large segment of the commercial banking industry. This broad industry support is an important reason why the opportunity still exists to enact financial services modernization legislation.

SIA supports key provisions of H.R. 10 because they go a long way toward meeting the three principles upon which any financial modernization legislation should be built:

1) Functional Regulation: One federal agency should apply the same set of rules to the same activity engaged in by any financial institution, regardless of the type of

financial institution it may be. This protects investors and eliminates unfair competitive advantages.

2) Two-Way Street: Securities firms should be permitted to fully and freely affiliate with banks in a financial holding company, just as banks can affiliate with securities firms.

3) Competition Without Federal Subsidies: Securities activities should be performed in separately capitalized affiliates of banks, and those affiliates should not receive a competitive advantage from the insured deposits or credit power of a federally insured bank.

H.R. 10 creates a new regulatory structure that would enhance the competitiveness of financial services firms by permitting securities firms, insurance companies, and banks to freely affiliate in a holding company structure. Increased competition between financial services firms will reduce costs, give consumers more choices, and help the United States financial services industry maintain its preeminent status in the global economy. Under H.R. 10, the holding company would be regulated by the Federal Reserve Board. Each of the subsidiary financial institutions would be registered broker-dealers and generally would be functionally regulated, thereby bolstering investor protection and fair competition. H.R. 10 effectively prevents a bank from using its insured deposits to fund the activities, directly or indirectly, of its securities affiliate. SIA believes this financial services regulatory structure is conceptually far superior to today's archaic system.

Congress is the only body that can comprehensively alter the regulatory system in a manner that is fair to all segments of the financial services industry and in the best interests of financial services consumers. Today, financial institutions are affiliating with one another at a dizzying speed under a regulatory system that was intended to ban such affiliations. These affiliations are the result of piecemeal decisions by banking regulators that have permitted banking organizations to acquire securities firms, while securities firms generally remain prohibited from acquiring commercial banks. Moreover, even if a securities firm were to acquire a bank, the combined entity would become subject to the Bank Holding Company Act, even though that law was not designed to accommodate many of the ordinary and customary activities of securities firms (such as securities underwriting and dealing, merchant banking, venture capital, commodities and various other activities). Many of the current restrictions on bank affiliates were imposed prior to the invention of computers, fax machines, ATMs, the Internet, and various other technological innovations that have transformed the financial services industry. Such impediments make little sense in today's technologically sophisticated, highly competitive and global financial world.

Yet, as shown in the attached chart (Exhibit 1), financial services providers continue to affiliate under the current regulatory framework despite outdated restrictions that drive up the cost of affiliations and limit the competitiveness of the combined firms. In the last two years, banks have acquired more than 50 securities firms. Financial services firms affiliate in response to their customers' and clients' demands and to remain competitive in the financial marketplace. The financial services industry will continue to evolve regardless of whether financial services modernization legislation is enacted. It is simply not desirable or possible to maintain the status

quo. The fundamental policy question for Congress is not whether these affiliations should occur, but what regulatory system should govern the combined entities. Surely, it should not be the current patchwork regulatory scheme that gives some financial institutions unfair and irrational competitive advantages over other financial institutions, and that permits many financial activities to be conducted outside of the supervision of the appropriate functional regulator. SIA believes these combined entities should be regulated under a system similar to that proposed in H.R. 10 in order to enhance the competitiveness of all financial services firms and functionally regulate their financial activities.

The U.S. securities industry is perhaps as competitive as any industry in the world. It is in part a result of that competition – including the ability to affiliate with entities other than banks – that the U.S. capital markets are the world's largest and most liquid. In the securities markets, one need only look at the vast choices in products, services, providers, and methods of compensation to see how competition has greatly benefited investors. Consumers can invest in stocks, bonds, and thousands of mutual funds. They can choose a full-service provider or a financial planner to receive advice on managing their assets. More independent and knowledgeable investors can use a discount firm to execute their transactions. Or they can make their trades electronically over the Internet for a fraction of the cost of just a few years ago. Investors can choose to compensate their broker in a traditional commission arrangement, a flat-fee basis, or as a percentage of assets under management. These changes greatly benefit investors and are the direct result of a highly diverse, competitive industry that is willing and able to invest the capital needed to meet the demands of its customers. Passage of financial

services modernization legislation would bring the benefits of competition, including cost savings estimated at $15 billion over three years, to the financial services marketplace.

H.R. 10 would also give customers more choices. Many individuals and corporate customers worldwide are demanding to have all their financial needs met by a single firm. The ability of securities firms, insurance companies, and banks to affiliate would allow a single financial services firm to meet those needs. Individuals may choose a full-service provider because they value something as simple as a single monthly statement showing their checking account balances, securities holdings, retirement account investments and insurance policy values. Corporate customers might take advantage of banking, securities, and insurance services from one provider without having to reveal confidential information to several different entities.

For many years, SIA has supported financial modernization legislation that embodies the principles of functional regulation, a two-way street, and competition without federal subsidies. We believe that fundamentally H.R. 10 satisfies those three principles.

First, the legislation would require each financial institution to be functionally regulated. One regulatory agency should apply the same set of rules to the same activity engaged in by any financial institution, regardless of the type of institution it may be. SIA strongly believes that the Securities and Exchange Commission ("SEC"), the securities self-regulatory organizations ("SROs"), and the state securities agencies should regulate securities activities regardless of what entity performs those activities. Similarly, the appropriate federal or state banking regulator should regulate banking activities, and the appropriate state insurance regulator should regulate insurance activities. Functional regulation assures that the most knowledgeable regulator is

supervising a financial institution's activities. In the securities markets, all participants would be equally subject to the principle of complete and full disclosure and regulation by the SEC and SROs. The guiding principle of disclosure protects investors, encourages innovation, and ensures fair markets. Indeed, under this regulatory structure, the U.S. capital markets have set the global standard for integrity, liquidity, and fairness. Investors understand the protections they are afforded and market participants understand their obligations.

Moreover, functional regulation eliminates regulatory discrepancies and the resulting competitive advantages between financial services firms engaging in the same activities. Under H.R. 10, all securities activities would be performed outside of a bank, except for a small number of carefully defined securities activities that traditionally have been conducted in banks with the benefit of SEC, SRO and state securities administration regulation.

Second, the legislation generally provides for a two-way street, by permitting securities firms, insurance companies, and banks to freely affiliate with one another, on the same terms and conditions, and to engage in any activity that is financial in nature.

Third, the legislation should not permit securities, insurance, and other non-banking activities to be covered by, and potentially to jeopardize, the deposit insurance system. H.R. 10 protects the deposit insurance system from the risks imposed by securities and insurance activities. With certain exceptions, H.R. 10 provides that all securities and insurance activities must be conducted in separately capitalized affiliates of a bank, rather than in the bank itself. As a result, these activities would not pose a risk to the deposit insurance system and taxpayers would not be forced to indirectly subsidize banks that engage in those activities.

SIA also supports other key provisions in H.R. 10. For example, H.R. 10 would create wholesale financial institutions ("WFIs"), which are banks that do not accept deposits that are insured by the federal government – that is, they generally do not accept deposits under \$100,000. WFIs would provide commercial banking services to institutional customers without imposing any risk to the bank insurance fund or U.S. taxpayers. SIA strongly supports the inclusion of WFIs in H.R. 10.

Mr. Chairman, last session SIA supported H.R. 10 and worked actively to pass it. That bill, while not perfect, represented a series of compromises by every sector of the financial services industry. Although there were a number of provisions that SIA believed could be improved, we supported the bill because we were committed to maintaining the delicate consensus compromise that emerged among all the participants. H.R. 10 represented a fair and thoughtful approach to balancing the competing interests of a wide range of financial services providers and regulators. Most importantly, the regulatory structure proposed in H.R. 10 was, and is, a vast improvement over our current regulatory system.

SIA remains committed to passing that consensus version of H.R. 10. However, as in years past, there are several areas of the bill that SIA continues to believe could be improved. These issues include:

- The need to increase securities firms' ability to affiliate. Securities firms, insurance companies, and other diversified financial firms currently may affiliate with non-financial firms. SIA believes that financial services modernization legislation should reflect current market practices and permit commercial affiliations to continue. Existing

commercial affiliations have not weakened securities, insurance, and other financial services firms, and there is no reason to believe that permitting banks to similarly affiliate with commercial companies will endanger banks. Indeed, the experience under the unitary thrift charter, which currently permits commercial firms to own or affiliate with a thrift, is powerful empirical support for this view.

- The definition of "financial in nature" should be amended to include activities that are complementary to activities that are financial in nature, in order to allow securities, insurance, and other financial services firms to continue providing long-standing and important services to their customers. For example, a financial services firm should not be prohibited from offering to its customers, as an adjunct to its financial services, access to a web site that permits them to purchase non-financial products related to the firm (such as cups, shirts and travel bags with the firm's logo), or from expanding that service to include other non-financial products.

- Broadening the description of permissible merchant banking activities to assure that current market practices are not inadvertently restricted. For example, because of the restrictions in H.R. 10 against a securities firm becoming involved in the company's day-to-day management operations, it might be unduly limited in its ability to interact with the management of a company it acquired in a merchant banking transaction. Similarly, the securities firm might be required to divest that company in a "fire sale" because of the bill's restrictions on the length of time the company could be owned.

- Reducing the significant role of the Federal Reserve Board over financial holding companies. Reducing the role of the Fed would prevent unnecessary and counterproductive regulatory interference in the business activities of the functionally regulated subsidiaries and in the business operations of the holding company. The Federal Reserve Board's authority should be limited solely to powers necessary to protect the safety and soundness of insured depository institutions, and to protect against systemic risk.

- Deleting the provisions in H.R. 10 that would require bank regulators to adopt uniform rules regarding fees and markups for non-deposit products. Among other reasons, SIA believes that the rules of the SEC and SROs should uniformly govern the sales practices of all sellers of securities, and Congress should not legislatively authorize the creation by the banking regulators of a second, potentially inconsistent system.

- Prohibiting banks from conducting securities brokerage and insurance agency activities in operating subsidiaries. SIA believes all securities activities by bank affiliates should be conducted in a subsidiary of the holding company, rather than the bank, in order to prevent, for example, competition disparities that could result from different regulation by the Federal Reserve Board and the Comptroller of the Currency.

- Deleting the provisions that permit banks to directly underwrite and deal in municipal revenue bonds. SIA has long argued that bank securities activities should be limited solely to those which banks historically and actually have performed. All other securities

activities – including underwriting and dealing in municipal revenue bonds – should be conducted in an affiliated broker-dealer registered with the SEC.

SIA worked with you, Mr. Chairman, members of this Committee, others in Congress, and many in the financial services community to reach a number of the compromise positions that were reflected in H.R. 10. The progress we made cannot be overstated. Passage of financial services modernization legislation has long been SIA's number one legislative goal. While we support H.R. 10, we believe certain changes could make it more valuable to investors, consumers, and the financial services industry. We remain open to examining alternative legislation that meets our fundamental principles. As of today, no other legislation has been introduced that meets our principles to the extent H.R. 10 does.

Mr. Chairman, we look forward to working with you, members of your Committee, as well as the House, Senate, and Administration to enact financial services reform legislation this year.

Testimony of

Scott Jones

On Behalf of the

American Bankers Association

Before the

Committee on Banking and Financial Services
United States House of Representatives

February 10, 1999

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On Behalf of the American Bankers Association
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Mr. Chairman, I am Scott Jones, Chairman of the Board of Goodhue County National Bank in Red Wing, Minnesota, and President of the American Bankers Association (ABA). I am pleased to be here today to present the views of the ABA on modernizing the structure of our financial system. The ABA brings together all categories of banking institutions to best represent the interests of this rapidly changing industry. Its membership – which includes community, regional and money center banks and holding companies, as well as savings associations, trust companies and savings banks – makes ABA the largest banking trade association in the country.

Mr. Chairman, we thank you for introducing H.R. 10 this year, and for holding hearings early in this new session. As we all know, the path towards the enactment of financial modernization has been long and difficult, but real progress has been made. Your leadership and the efforts of this Committee are responsible for much of that progress. Indeed, this Committee, on a ***bipartisan basis***, has done an incredible amount of work to move financial modernization forward. It is only appropriate that this Committee start today what we hope will be the final chapter.

This year, proponents of financial modernization have reason to be encouraged. The fast start in your Committee, coupled with the announcement by Senate Banking Committee Chairman Gramm that he intends to move forward very quickly, gives this legislation a significant boost. At the end of last year there was a growing consensus among many interested parties, including the various sectors of the financial services industry, on how to approach financial modernization. That approach is generally embodied in the language you have introduced in H.R. 10. Given the broad support for that language at the end of last year, we believe that H.R. 10 is the right place to begin the debate this year, and we applaud you for introducing it.

Clearly this approach represents compromise among many parties, including the ABA. We recognize that changes will be made in this legislation during the Congressional process. However, we agree with recent statements you have made, Mr. Chairman, that no party – including ABA – will get everything it wants in the final legislation. All parties must be willing to compromise in the interest of enacting financial modernization; we pledge to work with this Committee to achieve that goal.

It is very important that we move forward this year. With each passing day, the marketplace gets further and further ahead of our existing regulatory structure. In fact, this may well be the last opportunity Congress will have to address the issue of commercial ownership of banking institutions through the unitary thrift holding company. This concern is a major focus of my testimony.

Whether banking and commerce are combined will fundamentally alter our economy and our political structure. This combination should not be undertaken until there is a Congressional determination that this is the direction in which our country should move. The marketplace, however, is not standing by waiting for Congress to act. It will move so fast and so far, that there will be no way to put the genie back in the bottle. We believe Congressional action to stop further ownership of banking institutions by commercial firms is critical.

Over the last few years, we have worked with members of this Committee on various approaches to resolving the unitary thrift holding company situation, including merging the bank and thrift charters. It was our preference at the beginning of the last Congress to merge the thrift and bank charters into a new ***improved*** charter; this apparently is not in the cards at this time. Instead, H.R. 10 addresses the unitary thrift issue by maintaining a separate thrift charter but prohibiting commercial ownership of thrift institutions going forward. The significant grandfathering for existing unitary holding companies contained in H.R. 10 would address the concerns raised by the limited number of commercial unitaries that would have been affected.

This language represents an acceptable compromise that the banking industry supports. Importantly, America's Community Bankers agreed to support the Senate version of this legislation last year, which contained an identical provision. We hope the Committee will approve the language in H.R. 10 dealing with the unitary thrift issue. ***For many banks around the country, particularly community banks, this provision is critical for banking industry support for the entire bill.***

In my statement today, I would like to first discuss the need for financial modernization, and then turn to further discussion of the unitary thrift issue.

I will also briefly mention our position on some of the important provisions related to securities, insurance, and the Federal Home Loan Bank System. Finally, I would like to discuss the need to resolve the debate regarding operating subsidiary authorities. Detailed comments on the securities and insurance provisions will be submitted for the record by the ABA Securities Association and the ABA Insurance Association. These subsidiaries of the ABA follow these issues in detail and have worked closely with members of this Committee and others over the last Congress to help develop a workable framework for reform.

I. The Need for Financial Modernization

The virtually unanimous agreement among financial service providers that the time has come to modernize our financial structure is perhaps the most obvious evidence of the need for reform. Revolutionary improvements in technology and escalating competition are redefining the financial services business. The lines between different types of financial service firms have been blurred beyond recognition.

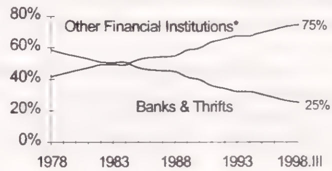
Today, my customers have the option to write a check on a money-market mutual fund to pay their bills; they can have a credit card issued by a phone company; and they can get a home mortgage from an automobile manufacturer. The list of non-traditional suppliers of financial services competing for my customers gets longer every day. Even defining the term "financial service" is becoming difficult in today's market.

As dramatic as the recent changes have been, they will surely be dwarfed by those that will occur over the next few years. In this dynamic market, the ability to quickly and efficiently respond to changing customer needs is critical. Successful firms must be flexible, innovative, and able to offer a broad range of financial services. As a banker, I can tell you that finding ways to compete successfully in these rapidly evolving markets without tripping over the outdated regulatory banking framework is no easy task – and it is absorbing a considerable amount of time, energy, and resources of large and small banks across the country.

Under the current regulatory regime, banks have lost traditional market share to other financial service providers. In fact, the market share of total assets held by banks and thrifts has fallen steadily over the past two decades, from almost 60 percent to 25 percent. On the other hand, securities and insurance firms like Merrill Lynch and Prudential offer everything from consumer and commercial loans to credit cards, securities, insurance and real estate products without having to jump through a series of regulatory hoops. Not only can these firms affiliate with each other, but many also own FDIC-insured savings institutions or "non-bank" banks.

Bankers are working to offer the products our customers want, although in many cases the current framework makes this process more difficult and expensive than it would otherwise be. For example, Section 20 subsidiaries allow some large bank holding companies to offer securities underwriting services, but this is not a practical structure for small banks or even for mid-sized banks.

Market Share of Assets Held by Financial Institutions



Source: Federal Reserve Board, *Flow of Funds*
* Insurance Cos. (42%), Investment Cos. (23%), Security Cos. (4%), Finance Cos.(4%), Credit Unions (2%)

Simply put, the bank regulatory structure needs to be modernized to allow all institutions the option to enter lines of financial business without having to jump through costly regulatory hoops. Not all banks will choose to offer all services. But the decision of what products and services to offer should be a business judgment that each

individual institution is free to make. It simply makes no sense to perpetuate a system that limits free and fair competition. Doing so means that customers will not be well served.

Ensuring that consumers are well served should be a primary focus of the Committee. The costs and lost efficiencies of the current system are ultimately borne in large part by the consumers of financial services.

This legislation is also important to our country's international competitiveness. Despite our archaic laws, this country is the international leader in financial services – to the great benefit of our economy. However, we cannot maintain that leadership unless our laws are brought up-to-date.

II. The Unitary Thrift Holding Company Issue Should Be Addressed

Addressing the unitary thrift holding company issue in the financial modernization bill is vital. We believe that any bill that does not adequately address this issue is fatally flawed. At the heart of the unitary thrift issue is whether it is appropriate to mix commerce and banking. Mr. Chairman, last year the House, in a vote on your amendment, rejected the notion that bank holding companies should be able to offer even a small "basket" of non-financial activities. This would certainly appear to indicate that the House objected to the mixing of banking and commerce.

However, if the current unitary thrift situation – which allows any commercial firm to enter the banking business merely by buying a thrift – is not addressed soon, commerce and banking will certainly be mixed. For example, Microsoft or General Motors could buy a small thrift with what would amount to them as spare change. Note also that such a small thrift could then be merged with a very large bank, as long as the resulting institution were run as a unitary thrift.

This is a critical point – there is almost no difference between a thrift and a bank today. The tax incentive for thrifts to engage in housing finance has been eliminated, and the Qualified Thrift Lender test has been steadily eroded to the point where almost every commercial bank in the country qualifies or could easily qualify with minor asset adjustments. The only real difference is the ability to hold large commercial loans; but even this can be easily circumvented by selling off those loans or by setting up a commercial finance affiliate.

Thus, ***if Congress passes H.R. 10 without addressing the unitary thrift issue, it is a virtual certainty that our country will have permanently crossed the bridge to full banking and commerce.*** In a very short time, we will almost certainly see large commercial firms owning large banks. These banks will technically have thrift charters, but for all practical economic purposes, they will be banks.

In fact, since discussions in Congress began regarding the possibility of closing the unitary thrift option, interest in acquiring and chartering unitary thrifts has intensified. Seventy non-depository firms – including some large manufacturing companies like Ford and General Motors – either have an application pending or have already been granted a thrift charter. (See Table 1 for more details).

Table 1
Unitary Thrift Charter Applications as of December 31, 1998

Securities Brokerage/Investment
1. Paine Webber Group, Inc.
2. Legg Mason Inc.
3. Advest Group*
4. A.G. Edwards, Inc.*
5. Merrill Lynch & Co., Inc*
6. The Capital Group Companies, Inc.
7. T. Rowe Price Associates
8. Franklin Resources Inc.
9. Morgan Keegan Inc.
10. Fidelity Investments
11. Everen Capital Corporation
12. SMR Corporation

Manufacturing & Other Companies
1. Ford Motor Company (Manufacturing: Auto)
2. Archer-Daniels-Midland (Manufacturing: Agriculture)*
3. Hillenbrand Industries, Inc. (Manufacturing: Coffins, Urns)*
4. Temple-Inland, Inc. (Manufacturing: Paper and Forest Products)
5. Farm Bureau (Trade Group for Farmers and Agricultural Interests)
6. General Motors Corporation (Manufacturing: Auto)
7. Excel Communications, Inc. (Telecommunications)*
8. B.A.T. Industries/Imasco (Tobacco)*
9. UKROP's Super Markets, Inc. (Supermarkets)*
10. Deere, Co. (Manufacturing: Ag Equipment)
11. AGI (Miscellaneous/Marketing)

Other Nonbank Financial Companies

1. First Alliance Mortgage Company (Mortgage Co.)*
2. Partners First Holdings, LLC (Credit Card)
3. American Express Company (Diversified Financial)
4. First American Financial Company (Finance Company)
5. GE Financial Services (Diversified Financial)
6. GMAC Mortgage Co. (Mortgage Company)
7. VanVlissingen Trust (Family Trust)
8. Nordstrom, Inc. (Retailer)
9. Private Bankcshares, Inc. (Mortgage Company)

Source: Office of Thrift Supervision

Insurance Companies
1. State Farm Mutual Auto Insurance Co.*
2. American International Group
3. The Hartford Group
4. Aid Association of Lutherans*
5. Sun America, Inc.
6. CCC Holdings, Inc.*
7. Equitable Companies Inc.
8. American General Corporation
9. TIAA Board of Overseers*
10. Allstate Insurance Company*
11. AmerUs Group Company
12. Grange Mutual Casualty Co.
13. Transamerica
14. New Jersey Mfg. Insurance Co.
15. CNA Financial Corporation
16. First American Trust
17. Lumbermens Mutual Casualty Co.
18. Metropolitan Life Insurance Co.
19. ReliaStar Financial Corp.*
20. Cigna
21. Aetna, Inc.
22. GUARD Insurance Group, Inc.
23. Guardian Life Insurance Co.
24. INA Holdings Corporation
25. Washington Mutual, Inc. *
26. Peyton Financial Service Corp.
27. National Association of Mutual Ins. Co.
28. Nationwide Insurance Enterprises*
29. New York Life Insurance Co.
30. Shelter Mutual Insurance*
31. AAA/Auto Club Services, Inc.
32. Massachusetts Mutual Life Insurance Co
33. Polish National Alliance
34. American Sterling Corporation
35. Greentree Financial Services
36. Chicago Title Corporation
37. Fortis AMV
38. Kaiser Permanente

* Approved

H.R. 10 addresses this issue by prohibiting commercial ownership of banking institutions going forward, while providing significant grandfathering for existing unitary thrift holding companies. The grandfather provisions should take care of the limited number of commercial unitaries that would be affected. This is essentially the compromise reached last year in the Senate. We urge the Committee to approve this language.

The Parallel Banking System

The unitary thrift issue raises concerns even beyond the mixing of banking and commerce. As I noted above, there is little practical economic difference between a bank and a thrift. Yet there is a big difference in how their holding companies are regulated. In particular, the Office of Thrift Supervision (OTS) focuses its supervision on the subsidiary thrift, while the Federal Reserve imposes supervision at the holding company level. Most importantly, the Fed imposes capital requirements on bank holding companies, while there is no such requirement on thrift holding companies.

Failure to deal with the unitary thrift holding company issue would mean that Congress will have ***blessed two parallel banking systems, one with much stricter regulatory standards than the other.*** Economic theory tells us that resources will flow into firms with more regulatory advantages and out of those with less regulatory flexibility.

In the past, the unitary thrift holding company had not been used much because the thrift crisis and the deposit insurance premium differential tarnished the thrift charter. However, this is no longer the case, in large part as a result of thrifts recapitalizing the Savings Association Insurance Fund (SAIF) and commercial banks assuming a large share of the FICO obligations (bonds issued to repay the cost of thrift failures). Moreover, liberalization of the Qualified Thrift Lender test has also enhanced the usefulness of the charter by permitting thrifts to engage in a wider variety of banking services. The applications from non-depository institutions (noted in Table 1) clearly show the renewed interest in unitary thrift holding company charters. Over time, particularly with commercial interests taking advantage of the unitary thrift approach, billions of dollars will flow to that side of the parallel banking system.

I must add, Mr. Chairman, that many commercial bankers believe that Congress committed to address the unitary thrift issue and to combine the best aspects of the bank and thrift charters into a single, improved charter when it enacted the BIF/SAIF bill several years ago. In that legislation, commercial banks were required to pay over time roughly $12 billion in interest on FICO bonds issued to help resolve the thrift crisis, even though those banks had no responsibility for the thrift crisis.

At a minimum, we hope this Committee will address the unitary thrift issue in the context of financial modernization. If it is not addressed now, it is unlikely ever to be addressed. We believe it is possible to address the unitary thrift holding company issue while maintaining a separate thrift charter. H.R. 10 provides a compromise on this issue that has had the support of both the banking and thrift industries.

III. Securities and Insurance Provisions

Securities Provisions

As the Chairman and members of the Committee are aware, the ABA, through its affiliate, ABA Securities Association (ABASA), worked long and hard during the 105th Congress to contribute to many of the capital markets and securities provisions now embodied in H.R. 10. ABASA had many constructive dialogues on these issues with members and staff of the House Banking and Commerce Committees and the Senate Banking Committee. In addition, numerous discussions and negotiations with the federal banking regulators, the Department of the Treasury, the SEC and various industry trade groups were held. Many of the capital markets and securities provisions now contained in H.R. 10 resulted from these discussions.

ABASA will submit a more detailed statement for the record in support of the capital markets and securities provisions of H.R. 10. In this statement, I would like to highlight some of the positive capital markets provisions of the bill:

- **Full securities underwriting and dealing authority.** The bill repeals Section 20 of the Glass-Steagall Act and expressly authorizes financial holding companies to engage in full securities underwriting, dealing, and market making activities. This activity is particularly important to those bank holding companies that have been prevented from underwriting mutual funds.

- **Removal of prohibition on director, officer, and employee interlocks.** Section 32 of the Glass-Steagall Act is repealed, removing the statutory prohibition on director, officer, and employee interlocks between a bank and any affiliate or unaffiliated securities firm that is primarily engaged in bank ineligible securities activities. This provision is particularly important to bank holding companies that offer proprietary mutual funds to their customers.

- **Merchant banking authority.** The bill specifically authorizes any financial holding company to make the kind of "merchant banking" or venture capital investments in other companies that investment banks routinely make today. This provision is necessary to level the playing field among all firms offering investment banking services.

- **Bank authority to underwrite and deal in municipal revenue bonds directly.** The bill authorizes a national bank to underwrite and deal directly in municipal revenue bonds, so long as the bank is well capitalized. This provision is especially important to the smaller, regional banking firms, like mine, that wish to offer full financial services to their local and state government customers without incurring the expense of establishing a full-scale underwriting and dealing affiliate firm.

- **Expanded definition of "financial in nature."** The bill permits financial holding companies to engage in a broad range of financial activities and grants the Federal Reserve Board flexibility to define those activities.

Mr. Chairman, ABA and ABASA support these very positive capital markets and securities provisions in H.R. 10. We pledge to work with you and the members of this Committee to ensure that these provisions are enacted into law.

Insurance Provisions

The treatment of insurance has for many years been one of the most troublesome aspects of financial modernization legislation. The current version of H.R. 10 strikes a balance on this issue based on negotiations late last year in which ABA, working in partnership with the New York Bankers Association, participated. While the insurance provisions continued to generate controversy, ABA agreed to support the Senate version with this improvement in it. Never before had agents' groups and ABA been able to reach a compromise, and that compromise is a very positive sign.

On one hand, H.R. 10 expands the insurance powers of banking organizations by permitting banks to affiliate with insurance firms, and by authorizing the sale of insurance by subsidiaries of national banks. These provisions will help banks to meet the insurance needs of their customers. On the other hand, the bill maintains the integrity of state insurance regulation, which is a principal concern of the insurance industry and the states. The bill's regulatory provisions are intended to ensure the fair application of state insurance laws to banking organizations and to reaffirm the Barnett case.

A more complete discussion of the insurance provisions in H.R. 10 will be provided in a statement to the Committee prepared by our affiliate organization, the American Bankers Association Insurance Association (ABAIA).

IV. Federal Home Loan Bank System Reforms

Mr. Chairman, we are pleased that H.R. 10 contains several provisions related to the Federal Home Loan Bank System that would be very helpful to banks and their communities. In particular, H.R. 10 contains a provision that would expand the ability of members of the Federal Home Loan Bank System (under $500 million in assets) to pledge small business, agricultural, rural development, and other low-income community development assets as collateral for System advances. ***This would be a major benefit to community banks in both rural and urban areas, and the ABA strongly supports more flexibility in pledging assets.*** Also helpful to banks and their communities is a provision easing membership eligibility requirements for banks with less than $500 million in assets.

Importantly, these two provision will help communities, particularly small communities. As you know very well, Mr. Chairman, many rural communities need access to loans and capital.

Yet, community banks, which generally lack access to national capital markets, are very much "loaned up." Those banks need liquidity to support loans in their communities, and these critical provisions will help provide it.

V. Operating Subsidiaries

Financial modernization should provide the flexibility for institutions to adapt to the rapidly changing marketplace and to structure the delivery of financial services to their customers in the best possible way.

This principle of "freedom to choose" has led us to historically support the operating subsidiary approach. The choice of organizational structure will clearly vary from company to company. Some banking firms will choose to offer some products and services through holding company affiliates; others may find it more efficient to use an operating subsidiary of the bank; and some others may choose to provide some products, where permissible, directly through the bank. Why different banking firms choose a particular structure is not what is important. What is important is that they have flexibility to choose the structure best suited to their business, market, and customers.

Freedom to choose the most efficient organizational structure is the best way to assure that customers will have access to low-cost, high-quality products and services. In addition to these benefits, there are some important public policy benefits of allowing banks to conduct new activities in an operating subsidiary. For example, the bank subsidiary structure creates stronger and more stable institutions; is less costly and less complex; is more user-friendly for most community banks; will make U.S. banks more competitive in world markets; and, as community groups have pointed out, will keep resources in the bank for purposes of the Community Reinvestment Act (CRA).

I would like to elaborate a bit on the very important issue of safety and soundness. Under an operating subsidiary structure, the earnings of the subsidiary flow directly to the bank. This means that conducting new activities in an operating subsidiary will help to diversify the bank's income stream. This diversification will lower the risk profile of the bank, reducing the probability of failure and the potential risk to the deposit insurance fund.

The importance of an operating subsidiary for bank safety and soundness was articulated in a joint article by former FDIC Chairmen Helfer, Isaac, Seidman. The article (which is attached to my testimony) states:

> *The big difference between the [operating subsidiary and holding company affiliate] comes when the activity is successful, which presumably will be most of the time. If the successful activity is conducted in a subsidiary of the bank, the profits will accrue to the bank.*

Should the bank get into difficulty, it will be able to sell the subsidiary to raise funds to shore up the bank's capital. Should the bank fail, the FDIC will own the subsidiary and can reduce its losses from the failure by selling the subsidiary.

If the company is instead owned by the bank's parent, the profits of the company will not directly benefit the bank. Moreover, should the bank fail, the FDIC will not be entitled to sell the company to reduce its losses.

Requiring that bank related activities be conducted in holding company affiliates will place insured banks in the worst possible position. They'll be exposed to the risk that the affiliates will fail without reaping the benefits of the affiliates' successes.

Moreover, offering nontraditional financial products and services does not increase the risk profile of the bank, regardless of whether these activities are conducted in an operating subsidiary or a holding company affiliate. Let me cite a few examples. First, banks already engage in a variety of securities and insurance activities, some within the bank or operating subsidiary and some through the holding company. None of these activities has led to safety and soundness problems.

Second, U.S. banks have successfully offered a variety of financial services (including securities and insurance underwriting) in foreign markets through branches or bank subsidiaries for many years. These activities have not led to safety and soundness problems.

Third, strong safeguards are already in place. There are strict regulatory limits on capital investment, terms and conditions of credit extensions, and other transactions between banks and their subsidiaries. In addition, FDIC can impose additional capital requirements for institutions engaging in non-traditional activities. The SEC, the security exchanges, and the security industry self-regulatory organizations also impose financial adequacy regulations, affiliate transaction requirements, standards of conduct, and reporting and examination requirements on securities firms.

As you are well aware, Mr. Chairman, the issue of operating subsidiaries was a major stumbling block to efforts to reform our financial system in the last Congress. We would not want this to impede the process this year, and we hope that a reasonable approach can be found that will bridge the gap in this area. We pledge to work to achieve such an approach.

One concept that may not have received adequate consideration is a proposal originally advanced by the Treasury Department in its 1997 draft legislation. This proposal, as amended in this Committee, would impose certain financial requirements on banks wishing to engage in underwriting activity in an operating subsidiary. For example, the bank must be well-capitalized (10 percent capital-to-assets ratio) ***after*** deducting its capital investment in the operating subsidiary. This imposes a capital restriction on ***all*** banking institutions regarding the size of the underwriting subsidiary they can operate. In many cases, these requirements make it a practical

necessity to use a holding company structure rather than an operating subsidiary when the underwriting entity is large relative to the bank.

If one runs the numbers on the larger banks, securities firms, and insurance companies, the practical result of these requirements is that no bank – no matter how big – will be able to acquire a significant underwriting entity through an operating subsidiary, but rather would have to run it through the holding company.

VI. Conclusion

Mr. Chairman, the goals of financial modernization are to strengthen our entire financial system and to promote more competition to the benefit of consumers. Whatever financial modernization bill is finally enacted will form the framework for our financial system for decades to come. And history has shown us that once new rules are in place, it will be very difficult to change them. Simply put, the financial structure that is ultimately put in place here must be done carefully and correctly, or it can have severe long-term consequences. Thanks to the hard work of this Committee in recent years, we are on the verge of enacting thoughtful financial modernization.

As a banker, I understand the importance of financial modernization. I need the ability to offer new products and services in order to meet the needs of my customers. ***I believe H.R. 10 has the right elements and provides a tremendous starting place for consideration in the 106th Congress.***

We look forward to working with you and this Committee to find fair and equitable solutions. Financial modernization is very important to our customers and the economy.

AMERICAN BANKER
September 2, 1998

Comment/ *By RICKI TIGERT HELFER, WILLIAM M. ISAAC, and L. WILLIAM SEIDMAN*

Ex-FDIC Chiefs Unanimously Favor the Op-Sub Structure

The debate on banks conducting financial activities through operating subsidiaries has been portrayed as a battle between the Treasury and the Federal Reserve. The Treasury believes banks should be permitted to conduct expanded activities through direct subsidiaries. The Fed wants these activities to be conducted only through holding company affiliates.

Curiously, the concerns of the Federal Deposit Insurance Corp. have been largely ignored. The FDIC, alone among the agencies, has no "turf" at stake in this issue, as its supervisory reach extends to any affiliate of a bank. The FDIC's sole motivation is to safeguard the nation's banks against systemic risks.


Helfer

In the early 1980s, when one of us, William Isaac, became the first FDIC chairman to testify on this subject, he was responding to a financial modernization proposal to authorize banks to expand their activities through holding company affiliates.

While endorsing the thrust of the bill, he objected to requiring that activities be conducted in the holding company format. Every subsequent FDIC chairman, including the current one, has taken the same position, favoring bank subsidiaries (except Bill Taylor who, due to his untimely death, never expressed his views). Each has had the full backing of the FDIC professional staff on this issue.

The bank holding company is a U.S. invention; no other major country requires this format. It has inherent problems, apart from its inefficiency. For example, there is a built-in conflict of interest between a bank and its parent holding company when financial problems arise. The FDIC is still fighting a lawsuit with creditors of the failed Bank of New England about whether the holding company's directors violated their fiduciary duty by putting cash into the troubled lead bank.

Whether financial activities such as securities and insurance underwriting are in a bank subsidiary or a holding company affiliate, it is important that they be capitalized and funded separately from the bank. If we require this separation, the bank will be exposed to the identical risk of loss whether the company is organized as a bank subsidiary or a holding company affiliate.


Seidman

The big difference between the two forms of organization comes when the activity is successful, which presumably will be most of the time. If the successful activity is conducted in a subsidiary of the bank, the profits will accrue to the bank.

Should the bank get into difficulty, it will be able to sell the subsidiary to raise funds to shore up the bank's capital. Should the bank fail, the FDIC will own the subsidiary and can reduce its losses by selling the subsidiary.

If the company is instead owned by the bank's parent, the profits of the company will not directly benefit the bank. Should the bank fail, the FDIC will not be entitled to sell the company to reduce its losses.

Requiring that bank-related activities be conducted in holding company affiliates will place insured banks in the worst possible position. They will be exposed to the risk of the affiliates' failure without reaping the benefits of the affiliates' successes.


Isaac

Three times during the 1980s, the FDIC's warnings to Congress on safety and soundness issues went unheeded, due largely to pressures from special interests:

- The FDIC urged in 1980 that deposit insurance not be increased from $40,000 to $100,000 while interest rates were being deregulated.
- The FDIC urged in 1983 that money brokers be prohibited from dumping fully insured deposits into weak banks and S&Ls paying the highest interest.
- The FDIC urged in 1984 that the S&L insurance fund be merged into the FDIC to allow the cleanup of the S&L problems before they spun out of control.

The failure to heed these warnings — from the agency charged with insuring the soundness of the banking system and covering its losses — cost banks and S&Ls, their customers, and taxpayers many tens of billions of dollars.

Ignoring the FDIC's strongly held views on how bank-related activities should be organized could well lead to history repeating itself. The holding company model is inferior to the bank subsidiary approach and should not be mandated by Congress.

Ms. Helfer, Mr. Isaac, and Mr. Seidman are former chairmen of the Federal Deposit Insurance Corp.

STATEMENT FOR THE RECORD

OF

THE ABA INSURANCE ASSOCIATION
("ABAIA")

BEFORE THE

COMMITTEE ON BANKING AND FINANCIAL SERVICES

UNITED STATES HOUSE OF REPRESENTATIVES

ON

THE "FINANCIAL SERVICES ACT OF 1999"

H.R. 10

FEBRUARY 16, 1999

The American Bankers Association Insurance Association ("ABAIA"), an affiliate of the American Bankers Association, is pleased to submit this statement on H.R. 10, the Financial Services Act of 1999. ABAIA's members are actively engaged in the business of insurance. Within the United States, we sell insurance products and annuities and we underwrite limited forms of insurance, such as credit life insurance. Outside the United States, we may sell all forms of insurance and may underwrite life insurance, annuities, and certain lines of property and casualty insurance.

What distinguishes ABAIA's members from other insurance firms is that we are part of banking organizations. This is a distinction that, we believe, benefits our customers. We are able to offer insurance products and annuities through a variety of outlets, including branches, many of which are located in low- and moderate-income areas. We also are able to offer our insurance customers a variety of other financial products, including deposit and loan products.

Unfortunately, as banking organizations, we cannot fully satisfy the insurance needs of our customers. Current federal law places various prohibitions and restrictions on the domestic insurance activities of banking organizations. Similarly, many States have imposed legislative and regulatory impediments to the provision of insurance by banking organizations. In Ohio, for example, the Department of Insurance continues to impede the sale of insurance by banks and their affiliates, using an old statute that prevents agencies affiliated with banks from receiving more than 50 percent of their premium volume from sales to customers of the bank.

H.R. 10 would remove many of these barriers. It would permit banks to affiliate with full service insurance firms. It also is intended to ensure the fair application of State insurance laws to banking organizations. On the other hand, H.R. 10 would not remove all of the barriers to the provision of insurance by banking organizations. It would not permit national banks to underwrite insurance, and certain State insurance laws would not be subject to the bill's anti-discrimination standards.

We recognize that any bill must reflect competing interests. As noted below, there are areas that concern us. However, last year, ABAIA participated in the negotiations which led to the provisions contained in H.R. 10, and we did agree to support those compromise provisions. We believe that H.R. 10 strikes a balance between the interests of the banking industry, the insurance industry, federal and State regulators, and, most importantly, consumers of insurance products.

Holding Company Affiliations

H.R. 10 would permit holding companies that meet certain eligibility requirements to own banks and subsidiaries that underwrite, broker, or sell insurance and annuities. For ABAIA, this is the most significant feature of the bill. Increasingly, our customers demand a mix of financial products and services. Affiliations between banking and insurance firms and the cross-marketing opportunities that will flow from such affiliations would enable us to meet these demands. Furthermore, we have witnessed the integration of banking and insurance outside the United States. Thus, H.R. 10 also would enable U.S. financial services firms to remain competitive in the global market.

The provisions of Section 104(a) of H.R. 10 are a necessary complement to the authority for banks to affiliate with insurance firms. Section 104(a) would preempt State laws that prevent such affiliations. There are a handful of States (and Puerto Rico) that continue to have such laws on their books, and without Section 104(a), these laws would frustrate one of the fundamental purposes of H.R. 10.

The Insurance Activities of National Banks

H.R. 10 would permit national banks that meet certain qualification requirements to sell insurance through operating subsidiaries. Currently, national banks may sell insurance from offices located in places with a population of less than 5,000. However, this so-called "place of 5,000" authority is cumbersome to use. Thus, the ability to sell insurance from an operating subsidiary regardless of its location is a welcome addition to the powers of national banks.

On the other hand, H.R. 10 would prohibit national banks and their subsidiaries from underwriting insurance. This prohibition reflects various policy concerns that have been expressed by some, most notably the Federal Reserve Board. First, there is expressed the concern that activities conducted in an operating subsidiary of a national bank pose a greater risk to the bank than activities conducted in a holding company affiliate. Second, there is an expressed concern that operating subsidiaries of a national bank would not be subject to functional regulation. Finally, some have suggested that if a national bank encountered financial difficulties, the viability of an insurance subsidiary could be threatened. While, as noted, we agreed to support the insurance provisions in H.R. 10 last year, the Committee should be aware that there are answers to each of these concerns.

Concerns over risk could be addressed by insulating an operating subsidiary from its parent, just as affiliates are insulated in a holding company structure. For example, the Committee could require that a bank's total investment in an operating subsidiary be deducted from its capital. Thus, even if the subsidiary were to fail, the bank's capital would not be impaired. Similarly, the Committee could place restrictions on extensions of credit from a parent bank to an operating subsidiary.

As for concerns over functional regulation, operating subsidiaries of national banks already are subject to the same functional regulatory schemes as any other company. For example, when the OCC recently permitted an operating subsidiary of Zions National Bank to underwrite municipal revenue bonds, it explicitly stated that the subsidiary was subject to the full range of SEC regulation.

Any potential risk posed to an insurance subsidy by a parent bank could be addressed by extending the terms of Section 113 of H.R. 10 to subsidiaries of national banks. Section 113 gives State insurance regulators the power to prevent banking regulators from taking funds from an insurance company to benefit an affiliated bank.

Finally, one of the products national banks are explicitly prohibited from underwriting is title insurance. This provision, which appears in Section 306 of the bill, is simply at odds with the purposes of financial modernization. If there is one insurance product that could benefit from increased competition it is title insurance.

State Regulation of Insurance

H.R. 10 reaffirms the authority of States to regulate insurance. It also places important limitations on the ability of States to adopt regulations that discriminate against banks engaged in the sale of insurance. Today, several States have laws and regulations that impose unfair and unnecessary requirements on banks engaged in the sale of insurance. Thus, the provisions in Sections 104(b) and (c) of the bill are among the more significant in the bill.

Sections 104(b) and (c) also are among the more complex provisions in H.R. 10. To a large degree, this complexity reflects the fact that these provisions have been the subject of extensive negotiations between the banking and insurance industries. The provisions are not ideal, but they do represent a fragile compromise between the banking and insurance industries. They establish basic standards against which State insurance sales laws and regulations will be judged. We must tell you that the thirteen categories of State law that fall within the so-called "safe harbor" have been the subject of much debate within our industry. Some, particularly in States with histories of discrimination, are concerned that the safe harbor will be used in a discriminatory fashion. Nevertheless, the "safe harbor" created by Section 104(b)(2)(B) is subject to an "arbitrary and capricious" review standard in State courts, and, we believe, any State law would be subject to a reasonableness test in federal courts. Furthermore, we believe that Section 104(b) preserves the Barnett standard.

Consumer Protection

H.R. 10 directs the federal banking agencies to issue consumer protection regulations that apply to the retail sales, solicitations, advertising, or offer of insurance by an insured depository institution or any person engaged in such activities at an office of such institution on behalf of such institution. Such regulations would prohibit coercion; require disclosures related to deposit insurance and investment risk; require, to the extent practicable, the separation of deposit taking and lending activities from insurance sales activities; prohibit the consideration of domestic violence in underwriting, pricing, renewing, or establishing the scope of coverage for any insurance product; and create a consumer grievance procedure. ABAIA recognizes that protecting consumers is an important feature of any financial modernization bill. We would suggest, however, that if Congress dictates the development of federal consumer protections, those protections should be uniformly applied to all consumers, regardless of their location. In other words, the federal regulations should prevail over State regulations on the same topic. Furthermore, it is impossible to understand why the domestic violence provision should apply only to insurance companies affiliated with banks; there simply is no connection.

Authority of the Federal Banking Regulators

H.R. 10 would create an expedited judicial review procedure and a new judicial review standard for certain disputes between federal banking regulators and State insurance commissioners. Obviously, we have no objection to expediting the review of any dispute. On the other hand, the Committee should be aware that the proposed standard of review in these disputes would prevent a federal court from applying the doctrine of judicial deference to insurance-related decisions by the Comptroller of the Currency and other federal banking regulators.

Federal courts have applied the doctrine of judicial deference to federal agency actions for over 200 years. The doctrine provides that a federal court will defer to an agency determination only if the law upon which the determination is based is ambiguous, the determination is within the scope of the agency's authority, and, finally, the agency's determination is reasonable. Thus, under current precedents, the doctrine is rather narrow.

There are strong public policy reasons for the doctrine. Most importantly, it leaves policy decisions under the control of agencies created by Congress and accountable to Congress. To eliminate the application of the doctrine is to place key policy decisions in the hands of the judiciary, which is not as accountable to the Congress.

The doctrine has been applied in various cases involving banks. For example, it was applied by the U.S. Supreme Court in the so-called VALIC case, which upheld an OCC determination that national banks could sell annuities. On the other hand, the 1986 Dimension case indicates that the doctrine offers no guarantee for an agency's action. In that case, the Supreme Court held that the Federal Reserve Board's interpretation of two statutory terms was unreasonable, and not entitled to deference.

Conclusion

ABAIA supports financial modernization and appreciates the opportunity to submit this statement to the Committee, and we would look forward to working with the Committee as it strives to modernize our nation's financial services laws.

STATEMENT FOR THE RECORD

OF

THE ABA SECURITIES ASSOCIATION
("ABASA")

BEFORE THE

COMMITTEE ON BANKING AND FINANCIAL SERVICES

UNITED STATES HOUSE OF REPRESENTATIVES

ON

THE "FINANCIAL SERVICES ACT OF 1999"

H.R. 10

FEBRUARY 16, 1999

The ABA Securities Association ("ABASA") is pleased to submit this statement for the record in connection with the hearings held on February 10-12, 1999, on H.R. 10, the "Financial Services Act of 1999."

ABASA is a separately-chartered subsidiary of the American Bankers Association ("ABA"), formed in 1995 to develop policy and provide representation for those bank holding companies involved in securities underwriting and dealing, proprietary mutual funds and derivatives activities.

ABASA appreciates the opportunity to provide its views regarding the securities and capital markets provisions of H.R. 10. As the Chairman is aware, ABASA has worked hard over the last three years to play a contributing role with respect to many of these provisions. Specifically, ABASA has had many constructive dialogues on these issues with members and staff of the House Banking and Commerce Committees, the Senate Banking Committee, the federal banking regulators, the Department of the Treasury and the Securities and Exchange Commission ("SEC"). In addition, during the 105th Congress, ABASA had, at the request of the then House Leadership, participated with our colleagues at the Securities Industry Association ("SIA), in compromise negotiations regarding many of the securities provisions contained in Title II. As a consequence, ABASA has a vested interest in ensuring that financial services reform legislation is enacted.

As with all negotiated efforts, H.R. 10 contains provisions that are supported by some, but not others. From the banking industry's perspective, H.R. 10 contains some very positive capital markets provisions that should prove to be beneficial to the industry and consumers alike.

These very positive provisions include:

- **Full securities underwriting and dealing authority.** By repealing § 20 of the Glass-Steagall Act, this new authority would apply only to holding company affiliates of banks.

- **Removal of the prohibition on director, officer, and employee interlocks.** Section 32 of the Glass-Steagall Act would be repealed thereby removing the statutory prohibition on director, officer, and employee interlocks between a bank and any affiliate or unaffiliated securities firms.

- **Merchant banking authority.** Allow bank holding companies to take principal positions in companies for investment banking purposes, an authority comparable to that permitted for investment banking firms today.

- **Bank authority to underwrite and deal in municipal revenue bonds directly.** The bill authorizes banks to directly underwrite and deal in municipal revenue bonds.

- **Expanded definition of "financial in nature."** The bill permits financial holding companies to engage in a broad range of financial activities and grants the Federal Reserve Board ("Board") or the Department of Treasury ("Treasury") flexibility to define those activities.

H.R. 10 also contains some provisions that, while not positive from the banking industry's perspective, are ones that we have been prepared to live with in the context of all parties working toward passage of landmark financial services reform legislation. We note that ABASA and the ABA supported the bill that was to have been considered in the Senate last year and that H.R. 10 incorporates the provisions of that bill, with a few relatively minor changes. Nevertheless, we will highlight some problematic provisions in this statement.

Mr. Chairman, ABASA believes that, while Title II will result in increased regulatory burdens and costs for our members, the provisions, for the most part, are workable. They are workable, Mr. Chairman, because this Committee and its staff, on a bipartisan basis, have patiently labored over the last three years to draft provisions that reasonably address the concerns of all those involved with these discussions. For this, Mr. Chairman, you, your Committee and staff are to be commended.

We believe a full understanding of each of the positive capital markets provisions is important to an effective analysis of H.R. 10. We have also included, where appropriate, discussion concerning the significance of various Title II securities provisions.

I. Positive Capital Markets Provisions

A. Full securities underwriting and dealing authority.

The bill repeals § 20 of the Glass-Steagall Act and expressly authorizes a financial holding company ("FHC") (the new type of bank holding company authorized by the bill) to engage in full securities underwriting, dealing, and market making activities. *See* § 101(a); § 103, new § 6(c)(3)(E) of the Bank Holding Company Act. Taken together, these provisions effectively remove the current prohibition on bank holding companies underwriting mutual funds and eliminate the existing 25 percent "gross revenue limit" on a bank affiliate's ability to underwrite and deal in bank ineligible securities.[1] These new authorities would apply only to a holding company affiliate of a bank; they would neither apply to the bank itself or its subsidiaries. The bill separately prohibits a subsidiary of a bank from underwriting or dealing in bank ineligible securities. *See* § 121(a).

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[1] Bank ineligible securities are securities in which the bank itself is not permitted to underwrite and deal. Generally, bank ineligible securities include commercial paper, certain asset-backed securities, corporate debt and equity, and securities of registered open-end investment companies.

B. Removal of prohibition on director, officer, and employee interlocks.

By repealing § 32 of the Glass-Steagall Act, the bill eliminates the statutory prohibition on director, officer, and employee interlocks between a bank and any affiliated or unaffiliated securities firm that is principally engaged in bank ineligible securities activities. *See* § 101(b). This provision is particularly important to bank holding companies that offer proprietary mutual funds to their customers.

Further, any safety and soundness concerns can be adequately addressed on a case-by-case basis. Specifically, the bill expressly provides the Board with broad authority to impose "prudential safeguards" on relationships or transactions between a bank and its affiliates. *See* § 114. The Board would have the ability to exercise such discretion by restricting interlocks, as it has done in the context of § 20 affiliates under current law.[2]

C. "Merchant banking" authority.

The bill specifically authorizes any FHC to make the kind of "merchant banking" or venture capital investments in companies that other investment banks routinely make today. This provision is necessary to level the playing field among all firms offering investment banking services. Although the bill preserves the Bank Holding Company Act's general prohibition on an FHC's ability to control a nonbanking company, it creates an exception for any merchant banking investment that satisfies certain restrictions: such investment activities are included in the bill's list of activities that are "financial in nature." *See* § 103, new § 6(c)(3)(H) of the Bank Holding Company Act.

Specifically, the bill permits an FHC to acquire an ownership interest in any company, whether or not technically constituting "control" of such company, if:

(a) the ownership interest is not held by a bank or a subsidiary of a bank;

(b) the ownership interest is held as part of a "bona fide underwriting or merchant banking activity";

(c) the interest is held only for such time "as will permit the sale or disposition thereof on a reasonable basis consistent with the nature of the [activity]"; and

(d) while the ownership interest is held, the FHC generally does not "actively participate in the day to day operation or management of [the company]."

See §103, new § 6(c)(3)(H) of the Bank Holding Company Act. In addition, a bank may not engage in (1) any cross-marketing activities with a company in which the bank's affiliate has made a merchant banking investment, or (2) any "covered transaction" with such a company (as

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2 *See* 12 CFR § 225.200(b)(3).

defined in § 23A of the Federal Reserve Act). *See* § 103, new §§ 6(f)(5) and 6(f)(6) of the Bank Holding Company Act.

D. **Bank authority to underwrite and deal in municipal revenue bonds directly.**

The bill authorizes a national bank to underwrite and deal directly in municipal revenue bonds, so long as the bank is well capitalized. *See* § 181 An operating subsidiary of a national bank would also be permitted to engage in these newly bank-eligible activities. This provision is especially important to the community banking firms that wish to offer full financial services to their local and state government customers without being required to incur the expense of establishing a bank holding company affiliate firm.

E. **Expanded definition of "financial in nature."**

The bill provides that a FHC can engage in any activity that is "financial in nature." *See* § 103, new § 6 (c) (1) of the Bankruptcy Company Act. In determining whether an activity is financial in nature, the Board, in consultation with the Department of Treasury, is to take into consideration, among other things, the purposes of the Bank Holding Company Act; changes in the marketplace in which the holding companies compete; changes or reasonably expected changes in the technology for delivering financial services, and whether the new activity is necessary to allow holding companies to compete domestically with other bank and non-bank affiliate financial services companies.

This provision gives the Board and the Department of Treasury sufficient flexibility to determine whether a proposed activity is financial in nature or sufficiently incidental to such activity as to be appropriate for holding companies to engage.

II. **Title II Securities Provisions**

A. **Subpart A**

Currently, banks have a blanket exemption from broker-dealer registration under the Securities Exchange Act of 1934 ("Exchange Act). Under the bill, banks would lose this blanket exemption and, as a consequence, if a bank were to engage in the Exchange Act's definition of "brokerage," the bank would have to register as a broker-dealer and be subject to regulation and oversight by the Securities and Exchange Commission ("SEC") and various self-regulatory bodies. As a practical matter, however, a bank would not register the entire bank. Instead, it would move the securities activities at issue out of the bank and into a separate brokerage subsidiary or affiliate.

This Committee, as well as many others involved in drafting H.R. 10, recognized, however, that banks had always "effected transactions in securities for the account of others"—the Exchange Act's definition of brokerage—and that these traditional banking activities should not trigger brokerage registration requirements. Accordingly, the bill lists several exemptions under which banks would **not** be required to push certain activities out of the bank and into a broker-dealer affiliate (the so-called "push-out" exemptions). While many existing securities

activities are covered by these push-out exemptions, it is important to understand that, as amendments to the federal securities laws, the exemptions would be subject to any narrow SEC interpretation.

Some of the more significant push-out exemptions are discussed below.

1. <u>Trust and fiduciary services</u>

If a bank effected a securities transaction in connection with providing trust or fiduciary services, the bank would be exempt from pushing these activities out of the bank and into a registered broker-dealer if three basic conditions were satisfied. First, the bank could not publicly solicit brokerage business, other than by advertising that it effected transactions in securities as part of its overall advertising of its general trust business. *See* § 201, new § 3(a)(4)(B)(ii)(II) of the Exchange Act.

Second, there are some limits imposed on the types of compensation that a bank may receive for effecting securities transactions. Specifically, the bank would have to be compensated primarily on the basis of: an administration or annual fee; a percentage of assets under management; a flat or capped per order processing fee that does not exceed the cost of executing the securities transaction for trust or fiduciary customers; or a combination of such fees. *See* § 201, new § 3(a)(4)(B)(ii)(I) of the Exchange Act.

Third, the bank would have to execute such brokerage transactions through a registered broker-dealer (which could include an affiliate), except for certain cross trades made by the bank or between the bank and an affiliated fiduciary. *See* § 201, new § 3(a)(4)(C) of the Exchange Act.

This push-out provision raises some very fundamental issues for our members. Specifically, if the activity is a trust or fiduciary activity, it should be exempted from the broker-dealer registration provisions of the federal securities laws without regard to the types of fees assessed. Long before the federal securities laws or the Glass-Steagall Act were enacted, commercial bank and trust companies served as trustees, executors, administrators, guardians and fiduciaries managing the assets of their clients according to the dictates of state law. As a traditional banking activity, banks should be permitted to continue to conduct these activities in the bank and in the manner prescribed by state and other fiduciary laws, without regard as to whether their compensation structure satisfies this push-out exemption.

In addition, the fee provisions are unduly burdensome in that they will force every trust bank to analyze each fiduciary account to ensure that the account satisfies the exemption's fee requirements and, thus, would not be required to be pushed-out of the bank and into a registered broker-dealer.[3] At last count, there were 2,200 banks and trust companies exercising

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[3] Banks would have recordkeeping responsibilities with respect to all of the exemptions. *See* § 205, adding new § 18(t) to the Federal Deposit Insurance Act.

discretionary trust powers for close to 1.4 million accounts.[4] Clearly, the regulatory burden associated with the fee provisions are substantial.

Despite the regulatory burdens associated with complying with the fee aspect of the exemption, the overall exemption is, ABASA believes, workable, especially as it no longer prohibits bank trust departments from using dual employees to service fiduciary accounts.

2. Stock purchase plan services

Banks that conduct stock transfer agency activities sometimes effect transactions in securities in connection with employee benefit plans, dividend reinvestment plans, and issuer plans. Such transactions in securities would be exempt from push-out if four conditions were satisfied. *See* § 201, new § 3(a)(4)(B)(iv) of the Exchange Act.

First, the bank could not solicit transactions or provide investment advice with respect to the purchase or sale of securities in connection with the plans. However, delivery of the types of written material permitted by the SEC as of the date of enactment (or as permitted by the SEC in the future) would not trigger a push-out.

Second, the bank could not net shareholders' buy and sell orders, other than for programs for odd-lot holders or plans registered with the SEC. (This condition would not apply to employee benefit plan activities.)

Third, as with the trust exemption, there are some limits imposed on the types of compensation that a bank may receive for stock purchase plan activities. Specifically, the bank would have to be compensated primarily on the basis of: administration fees; flat or capped per order processing fees (but without any restriction as to fees exceeding costs); or a combination of such fees. So long as the bank is *primarily* compensated in this manner, there does not appear to be any limit on other types of compensation it may received.

Finally, as with the trust exemption, the bank would have to execute any brokerage transactions through a registered broker-dealer (which could include an affiliate), except for certain cross trades made by the bank or between the bank and an affiliated fiduciary. *See* § 201, new § 3(a)(4)(C) of the Exchange Act.

Similar to the trust exemption described above, the fee provisions are most troubling for those banks that offer transfer agent services. Approximately 1,100 banks serve as transfer agents on behalf of U.S. corporations. While not all corporations offer their employees and others the ability to buy securities through the corporation's transfer agent, many do. Consumers like these plans as they allow small investors to buy individual stocks at competitive prices. Stocks can be purchased easily through payroll deductions and automatic withdrawals from bank accounts, as well as by check. Individuals who buy securities through these plans are buy and hold investors who might not otherwise be able to invest in these corporations.

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[4] Federal Financial Institutions Examination Council, Trust Assets of Financial

In establishing these programs, banks have responded to the needs of the investing consumer. To date, brokerage firms have not expressed an interest in offering similar services to investors. Consequently, consumers may be deprived of their ability to invest in a cost-effective manner in corporate America if the burdensome fee provisions contained in the exemption convince many banks to get out of the transfer agency business.

Moreover, banks that perform transfer agency services already comply with the SEC rules and regulations governing these activities. To the extent a bank performs these services directly in the bank, they are examined for compliance with the SEC's rules by their respective federal banking regulators. If a bank offers these services through a bank subsidiary or affiliate, then authority to examine these firms for compliance rests with the SEC. Consequently, it is hard to imagine what additional SEC regulatory authority over these entities is gained if transfer agents not satisfying the exemption's requirements are required to push these activities into a registered broker-dealer.

3. Banking products -- In general

Brokerage or principal transactions involving certain "banking products" would be exempt from push-out, even if the SEC were to label such a product a "security." The protected banking products are divided into two categories: "traditional banking products"; and "new banking products."

"Traditional banking products." The list of "traditional banking products" includes deposits; banker's acceptances; letters of credit; loans; and certain loan participations (as described below). *See* § 206(a). It also includes some derivative instruments (also described below). Importantly, this list of traditional banking products that are exempt from push-out is not included in the securities laws as are the other exemptions; instead, it is in a new, "free-standing" provision of law. The reason for creating this free-standing provision was to ensure that any SEC interpretation of traditional banking products did not receive the same kind of judicial deference that normally is accorded to SEC interpretations issued under the federal securities laws.

"New Products." A "new product" is an instrument that is not on the list of "traditional banking products" but was also not regulated as a "security" as of the date of enactment of the bill. *See* § 206(b). The SEC is given initial authority -- under the federal securities laws -- to determine, through rulemaking, whether a new product must be pushed out of a bank. Judicial review of that determination can be sought by any interested party, including a bank, and the court is required to make a final determination based on whether the product would be more appropriately regulated under the banking laws or the securities laws; the court must give equal deference to the views of the Federal Reserve Board and the SEC. Pending completion of any lawsuit, the new product would be stayed from being pushed-out of the bank.

ABASA has consistently urged that any new product provision be contained in the banking laws. We have done so in order to guard against courts giving unwarranted deference to

the SEC when it interprets whether a new product should be regulated under either the banking or securities laws. On balance, however, we recognize that § 206 is intended to provide for a neutral "jumpball provision" at the court of appeals level.

4. Qualified investor

The bill provides that certain exemptions from push-out depend on the instrument at issue being provided to a newly-defined category of sophisticated investor that is termed a "qualified investor." Specifically, the exemptions from push-out for the following four different types of financial instruments are conditioned in part on the instrument being provided to a "qualified investor": derivatives, private placements, loan participations, and asset-backed securities.

The qualified investor definition includes regulated entities such as banks, broker-dealers, insurance companies, pension funds, investment companies, etc., as well as any government of a foreign country. *See* § 207, new § 3(a)(55)(A) of the Exchange Act. It also includes (1) corporations and natural persons with at least $10 million in discretionary investments; (2) any government or political subdivision thereof with at least $50 million in discretionary investments; and (3) any multinational or supranational entity or any agency thereof (*e.g.*, the World Bank). *Id.*

While ABASA continues to be troubled by the introduction into the federal securities laws of yet another definition of sophisticated or qualified investor,[5] we generally support the bill's definition of qualified investor. We would suggest, however, that the net worth requirements be lowered to provide that qualified investor includes corporations with a net worth exceeding $1 million or total assets exceeding $5 million; any governmental entity with no minimum asset requirement. This approach will ensure that the concept of sophisticated investor as it applies to derivatives activities under both the federal securities and commodities laws are virtually identical.

5. Derivatives

Under the bill, derivatives that are deemed "securities" by the SEC would be pushed out of a bank unless subject to one of the following four types of exemptions:

(1) Complete exemption from push-out for principal or agency transactions in foreign currency derivatives. *See* § 201, new § 3(a)(4)(B)(ix) of the Securities Exchange Act of 1934; § 202, new § 3(a)(5)(C)(iv) of the Exchange Act; and § 206(a)(6)(A).

(2) Complete exemption from push-out for principal or agency transactions in interest rate derivatives that (a) are not based on a security or a group or index of securities (other

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[5] Already the federal securities laws contain at least four other definitions of sophisticated or qualified investors. These definitions serve many purposes, including whether or not securities have to be registered in order to be sold to certain investors.

than government securities, commercial paper, bankers' acceptances, or commercial bills); (b) do not provide for the physical delivery of a security (other than a government security, commercial paper, a banker's acceptance, or a commercial bill); and (c) are not traded on a national securities exchange. *See* § 201, new § 3(a)(4)(B)(ix) of the Securities Exchange Act; § 202, new § 3(a)(5)(C)(iv) of the Exchange Act; and § 206(a)(6)(B).

(3) Complete exemption from push-out for a derivative that is provided as principal to a "qualified investor" and that does not involve the physical delivery of a security. *See* § 202, new § 3(a)(5)(C)(v)(I) of the Exchange Act.

(4) Partial exemption for any type of derivative provided by a bank that the SEC deems to be a security but does not fall within the preceding three exemptions: such a derivative may continue to be booked in the bank (*i.e.*, not pushed out) so long as the purchase or sale of the derivative is effected through a broker-dealer, which may include an affiliated broker-dealer. *See* § 202, new §§ 3(a)(5)(v)(C)(II) and (III) of the Exchange Act.

ABASA believes that the derivatives provisions contained in Title II are confusing to say the least, especially when one considers how few derivatives activities are linked to non-exempt securities in such a manner that they could even conceivably be subject to the SEC's jurisdiction. Consequently, ABASA continues to advocate an approach whereby all derivatives activities are exempt from being pushed-out of the bank.

6. Loan participations

The bill includes loan participations on the list of "traditional banking products" that is codified in a free-standing provision of law. *See* § 206(a)(5). Loan participations deemed to be securities by the SEC would be eligible for two different types of exemption from push-out, depending on the circumstances.

First, an exemption from push-out would apply if the participation were sold to a "qualified investor."

Second, an exemption would apply for sales to non-qualified investors if the participations were sold to persons that (1) have the opportunity to review and assess any material information; and (2) have the sophistication necessary to evaluate such instruments, as determined by generally applicable banking standards.

7. Private Placements

The bill exempts private placements from push-out only if the placements are made to qualified investors and the bank has no affiliated broker-dealer other than one that underwrote or dealt solely in instruments that qualify as "exempted securities" under the Exchange Act. *See* §201, new § 3(a)(4)(B)(vii) of the Exchange Act.

The restriction on having an affiliated broker-dealer is unwarranted. Whether or not a FHC has an affiliated broker-dealer should not be determinative of whether traditional banking activities, *i.e.*, engaging in private placement activities, should be pushed out of the bank.

8. <u>Brokerage incidental to "networking" arrangements</u>

The bill exempts from push-out support services provided by bank employees to third-party and affiliated brokers in connection with the sale of securities to bank customers. In order to qualify for the exemption, such networking services must satisfy a number of conditions that closely parallel similar requirements in the Interagency Statement on Retail Sales of Nondeposit Investment Products ("Interagency Statement").[6] These conditions are:

- Clear identification that the broker is providing the brokerage services;
- Brokerage services are provided in an area that is clearly marked and, to the extent practicable, physically separate from deposit-taking activities;
- Advertising or promotional materials clearly indicate that the brokerage services are being provided by the broker, not the bank;
- Such materials comply with the federal securities law before they are distributed;
- Bank employees perform only ministerial or clerical functions in connection with the brokerage activities (but they can forward customer funds or securities and can generally describe the range of investment vehicles available);
- Bank employees (other than those who are "associated persons" of a broker-dealer) do not directly receive "incentive compensation" for any brokerage transaction (but they can receive referral fees if the compensation is a one-time cash fee of a fixed dollar amount and the fee is not contingent on a transaction occurring);
- All customers who receive brokerage services are fully disclosed to the broker-dealer;

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[6] The Interagency Statement was jointly issued by the Board, the Federal Deposit Insurance Corporation ("FDIC"), the Office of the Comptroller of the Currency ("OCC"), and the Office of Thrift Supervision ("OTS") on February 15, 1994. It was subsequently amended on September 15, 1995.

- The bank does not carry a securities account of the customer except as a custodian or trustee; and

- The customer is informed that the securities are provided by the broker, not the bank, and the securities are not deposits or other obligations of the bank, are not guaranteed by the bank, and are not insured by the Federal Deposit Insurance Corporation.

See § 201, new § 3(a)4)(B)(i) of the Exchange Act.

In this regard, we would share with the Committee our concern over the National Association of Securities Dealers ("NASD") recent attempt to assert jurisdiction over bank employees. Specifically, the NASD has filed a rule change and proposed interpretation with the SEC, through its wholly-owned subsidiary, the NASD Regulation, Inc.[7] The proposed interpretation could undermine this networking exemption as well as federal banking regulator guidance contained in the Interagency Statement.

Specifically, the proposal would prohibit an NASD-member firm from using unregistered persons to contact customers on behalf of the NASD member until the unregistered person acknowledges, in writing or by electronic means, that he or she is subject to the authority and jurisdiction of the NASD. Thus, under the proposed interpretation, bank employees would be required to submit to the NASD's jurisdiction solely as a result of calling on existing and prospective bank and broker-dealer customers and introducing these individuals to the complete package of products and services, including brokerage services, available to the customer through the bank holding company.

ABASA would submit that the NASD's proposed interpretation requiring bank employees to submit to the NASD's jurisdiction goes too far and would appear to conflict with the intent of this proposed legislation, namely that bank employees should be able to engage in limited securities marketing activities without triggering either SEC or NASD jurisdiction or oversight. ABASA has communicated these views to the SEC and NASD and is hopeful that the NASD will rethink its proposal.

h. <u>Safekeeping and Custody Services</u>

The bill exempts from push-out activities conducted in connection with safekeeping and custody services. Such services consist of the bank, as part of "customary banking activities"—

- Providing safekeeping or custody services with respect to securities, including the exercise of warrants and other rights on behalf of customers;

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[7] *See* Supervision of Unregistered Persons Performing Limited Marketing Activities; Release No. 34-40784; File No. SR-NASD-98-44; 63 <u>Federal Register</u> 70173 (December 18, 1998).

- Facilitating the transfer of funds or securities as custodian or clearing agency, in connection with the clearance and settlement of its customer transactions in securities;

- Effecting securities lending or borrowing transactions for customers, investing pledged collateral for customers, in connection with the safekeeping, custody and clearing activities described above; or

- Holding securities pledged by a customer to another person, or securities subject to purchase or resale agreements for a customer, or facilitating the pledging or transfer of such securities by book entry or as otherwise provided under applicable law.

See § 201, new § 3(a)(4)(B)(viii) of the Exchange Act.

This push-out exemption is very important to the banking industry. As more and more individuals change employers or retire, self-directed Individual Retirement Accounts ("IRAs") will become important vehicles, allowing consumers to individually manage their 401(k) retirement plan distributions. Under regulations issued by the Internal Revenue Service, banks must offer these IRAs in either a trustee or custodial capacity. Services provided to these accounts by banks functioning in a trustee or fiduciary capacity will be exempt from brokerage registration under the trust exemption discussed above. Services rendered by banks as a custodian will also be exempt under this safekeeping and custody exemption.[8]

i. **Sweep Account Activities**

More and more banks are offering their commercial, trust and other customers the ability to make their cash deposits productive by sweeping the cash on an overnight basis into an instrument earning some sort of return. Interest in these sweep services is particularly strong with small business customers. Many banks sweep customers funds into U.S. government securities or deposit accounts. Money market mutual funds is another popular option.

This bill would exempt banks that sweep customer funds into no load money market mutual funds.[9] To qualify for the exemption, the sweep service must be conducted as part of a program for the investment or reinvestment of banks deposits. *See* § 201, new § 3(a)(4)(B)(v) of

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8 *See* S. Rept. No. 105-336, 105th Cong., 2d Sess. at 10. "The [Senate Banking] Committee believes that bank custodial, safekeeping, and clearing activities with respect to IRAs do not need to be pushed-out into an SEC-registered broker-dealer." It would be helpful if the House Banking Committee adopted similar report language.

9 Sweep account services involving U.S. government securities or trust customers would be exempt under either the exemptions applicable to U.S. government securities or trust services. *See* § 201, new §§ 3(a)(4)(B)(ii) and 3(a)(4)(B)(iii) of the Exchange Act.

the Exchange Act. Mutual funds that assess service fees that do not exceed .25 of 1% of average net assets per annum are generally understood to be no-load. *See* NASD Rule 2830.

j. Statutory grievance procedure for retail purchases of securities from banks

The bill requires the bank regulators to impose sales practice rules and anti-tying rules on the *retail* sales of securities by a bank or any of its affiliates, unless such sales are made by an SEC-registered broker-dealer or a person acting on behalf of such a broker-dealer. *See* § 204. The sales practice rules are to be substantially similar to the Rules of Fair Practice of the NASD. The anti-tying rules to be imposed (*i.e.*, that extensions of credit could not be conditioned on the sale of a security) appear to overlap with those imposed under § 106 of the Bank Holding Company Act Amendments of 1970.

The provision further requires each bank regulator to establish procedures for processing complaints received by customers about violations of the new rules, and to develop a group or unit within each agency to receive such complaints. In addition, the regulators must develop procedures to investigate complaints, inform customers of their rights to complain, allow customers six years to make complaints, and permit the recovery of losses to the extent appropriate. The provision does not appear intended, however, to create a private right of action for an aggrieved customer. For the reasons cited below, we see no need for this provision.

First, this provision is aimed at direct retail sales of securities by smaller banks pursuant to the *de minimus* exception that permits up to 500 bank brokerage transactions each year without triggering the broker-dealer registration requirement. It makes little, if any, sense to direct the federal banking regulators to prescribe a whole series of sales practice and anti-tying rules and customer grievance procedures applicable to only that very small portion of the banks that will, once financial services legislation is enacted, directly engage in retail securities brokerage on behalf of their customers. The latest data indicates that 96% of all retail securities brokerage conducted through banks is effected through registered broker-dealers.[10] It is anticipated that that number will increase once financial services reform legislation is enacted.

Second, guidance offered by the Interagency Statement largely conforms to that mandated by § 204. Specifically, the Interagency Statement incorporates, where applicable, much of the sales practice provisions of the NASD's Rule of Fair Practice. Third, the six year statute of limitations mandated by § 204 appears excessive, especially when compared to the general three year statue of limitations standard established by the Exchange Act.

Finally, the anti-tying rules to be imposed (*i.e.*, that extensions of credit could not be conditioned on the sale of a security) would appear to overlap with those imposed under § 106 of the Bank Holding Company Act Amendments of 1970.

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10 1999 National Survey of Bank Retail Investment Services, Vol. I at 42.

B. Subpart B

The bill makes some changes to the regulation of bank investment company activities. These include: enhanced SEC regulatory authority over banks serving as custodians for affiliated registered investment companies (*see* § 211); enhanced SEC authority over bank lending to such companies (*see* § 212); expanded definition of "interested person," and current prohibition on majorities of mutual fund boards being affiliated with any one bank expanded to any one bank holding company (*see* § 213); enhanced SEC authority to require disclosures that mutual funds advised by or sold through a bank are not federally insured (*see* § 214); an investment adviser registration requirement for banks that act as investment advisers to investment companies, which can be accomplished through a separate department or division of the bank (*see* § 217); codification of bank common trust fund exemptive provisions (*see* § 221), and prohibition on bank trust departments having a controlling voting interest in a bank or bank-affiliated advised mutual fund (*see* § 222).

The latter provision, § 222, is of most concern to our members. Section 222 provides that if an investment adviser to a registered mutual fund holds a controlling interest (25% or more) in an advised mutual fund through shares held in a trust or fiduciary capacity, then the investment adviser must transfer voting authority to another fiduciary, vote the fiduciary shares in the same proportion as shares held by all other shareholders of the mutual fund, or vote the fiduciary shares according to some yet-to-be prescribed SEC rules or orders.

ABASA believes that § 222 is a remedy in search of a problem and should be deleted in its entirety from the bill. We are, however, very much aware that Title II has been carefully drafted with a view to accommodating the views of all industry participants. Consequently, we are in the process of meeting with various interested parties, including the SEC, to discuss whether an agreement can be reached to have this provision deleted from the bill. ABASA hopes to report back to the Committee on the results of these discussions in the very near future.

Conclusion:

In conclusion, Mr. Chairman, ABASA would like to reiterate its appreciation to those members of the House who have spent and continue to spend energy and time on modernizing our nation's financial services laws. ABASA's focus has been on securities and capital markets issues in general, and on Title II of H.R. 10 specifically. Our effort has been to play a constructive role in a process we hope will fairly balance the needs of all components of the financial services industry, the consumer, and the nation.

ABASA continues to stand ready to work with you and the Committee on this most important piece of legislation.

Testimony of

William L. McQuillan

On Behalf of the

Independent Bankers Association of America

Before the

Committee on Banking and Financial Services

U.S. House of Representatives

on

H.R. 10, the "Financial Services Act of 1999"

February 10, 1999

Good morning. Mr. Chairman and Members of the Committee. I am Bill McQuillan. president of the Independent Bankers Association of America and president of the City National Bank, an $18 million bank located in Greeley, Nebraska. I have just completed my second three-year term as an elected director on the Board of Directors of the Federal Reserve Bank of Kansas City. The IBAA represents some 5,500 independent community banks nationwide that hold nearly $445 billion in insured deposits, $524 billion in assets and more than $314 billion in loans to customers, small businesses and farms in the communities they serve. We employ more than 200,000 people in our communities.

Thank you very much for asking the IBAA to testify on H.R. 10, the Financial Services Act of 1999. And congratulations, Mr. Chairman, for keeping the H.R. 10 title.

Merger and Acquisition Wave Continues

Before getting into the details, H.R. 10 does authorize the common ownership of the largest banks, securities firms and insurance underwriters in the United States. We have asked the U.S. Court of Appeals for the District of Columbia Circuit to review the Federal Reserve's conditional approval of the application to merge Travelers Group and Citicorp -- an approval our lawyers feel is not consistent with existing law.

We are concerned about the potential anti-competitive effect these mergers are already having on ATM networks and credit and debit card markets. On January 25, for example, Citigroup co-chairman John Reed told the press that Citicorp, supported by Hugh McColl of Bank America and John McCoy of Banc One, would no longer promote the Visa and MasterCard brands. Clearly the erosion of these brands undercuts the competitive entry of thousands of community banks, thrifts and credit unions into the credit and debit card markets. The Bridge News story stated that Reed "hinted there will be a division between smaller banks and the megabanks that dominate the credit card industry" where "credit card lending has concentrated about 80 percent of the business among the 10 largest issuers."

And the merger and acquisition wave that continues to sweep through the banking industry and broader financial services industry is inevitably concentrating total domestic banking assets. There is a public policy issue here -- more too-big-to-fail institutions are being established at the very time when the Federal Reserve's actions of September 23 in orchestrating the bailout of Long Term Capital Management underscore the nature of the systemic risk that now faces our financial sector. It is worth recalling that Long Term Capital Management wasn't a depository institution covered by deposit insurance, yet the Fed took the unprecedented action to assure a bailout.

We are pleased, Mr. Chairman, that your bill does not open the can of worms of mixing banking and commerce by permitting banks to own commercial firms, but does shut the door to commercial firms using unitary thrifts towards this end. The banking and commerce door should not be opened in any way at this time for the sake of our marvelous diversified financial structure.

Progress on H.R. 10

Let me once again turn to the specific issue of H.R. 10. On the one hand it seems like we are on familiar ground here, having hashed and rehashed this issue over the last four years. But that is pretty much where the similarity ends. The fact is that since our testimony before this Committee last Spring, significant strides have been made to address the concerns of not only the banking industry, but also the interests of community banks. The bill that was reported out of the Senate Banking Committee last year contained a number of hard-fought compromises that led to the historic, but lost, opportunity last Fall for the Senate to pass legislation that was not opposed by any major sector of the financial services industry. The banking industry did oppose the House version of H.R. 10.

We applaud you, Mr. Chairman, for introducing legislation in this Congress containing the compromises worked out in Senate Banking, negating the unappealing prospect of re-waging old battles and re-negotiating existing compromises.

As part of our ongoing analysis of financial modernization legislation, seven standards have been developed by our policy committees that reflect our concerns and guide our policy considerations. These are:

Banking and Commerce

1. Banking and Commerce. The IBAA cannot support, and will oppose, any legislation that permits or encourages the common ownership of commercial banks and commercial firms. The case against banking and commerce is well established. Both Federal Reserve Board Chairman Alan Greenspan and Treasury Secretary Robert Rubin have raised serious concerns about moving in this direction at this time. Indeed, the House last year voted to remove even a 5 percent commercial basket from H.R. 10. We strongly support Chairman Leach's ongoing efforts to stop commercial banks and commercial firms from owning one another and applaud his statement of January 20 at the Exchequer Club that he would find it difficult to send legislation to the President with a commercial basket.

Allowing banks to own commercial firms would encourage financial institutions to engage in the kind of crony capitalism that has undermined the economies of Japan, Brazil and a number of Pacific Rim nations. It would be ironic, indeed, if the U.S. Congress followed this policy path at the very time these nations continue to struggle with an enormous economic and financial crisis fueled by this crony capitalism.

Allowing banks to own commercial firms also would jeopardize the impartial allocation of credit, which is the foundation of our highly successful economic and financial system. It would stretch the federal deposit insurance safety net to unintended areas, potentially weakening the linchpin that secures the very foundation of community banking and the stability of our banking system.

It also would put into play the "reverse basket," which under certain scenarios could permit Microsoft to buy Wells Fargo or Chrysler to buy Chase.

We very much appreciate the fact that Chairman Leach's new version of H.R. 10 maintains the separation of banking and commerce.

Unitary Thrift Holding Company Loophole

2. Unitary Thrift Holding Company Loophole. IBAA cannot support, and will oppose, any legislation that does not close the unitary thrift holding company loophole. This unfortunate provision of law permits unitary thrifts to be owned by any firm, including commercial firms, thereby breaching the banking and commerce wall. This loophole is of major concern to Chairman Greenspan. You may recall that last year Chairman Greenspan said that if this loophole were not closed by enactment of H.R. 10, he would support a moratorium on approvals of unitary thrift holding company applications filed by non-banks. Similarly, Treasury Secretary Rubin testified last year before the Senate Banking Committee that he, too, had concerns about this loophole.

We are pleased to note that Chairman Leach's bill includes a prospective restriction on commercial affiliations for any unitary thrift that was in operation on or before October 7, 1998, or had an application on file by that date and later became operational. This provision is certainly more than fair to existing unitaries which may continue their existing activities and may even acquire additional non-financial firms in the future. We are also pleased that the Leach language prohibits grandfathered thrifts from being sold to a non-financial firm in the future. One recommendation we could make would be to move the cutoff date back to the original date of introduction of H.R. 10 in the last Congress, because firms were clearly on notice at that time that Congress intended to close this loophole. We do not believe that those firms that applied for a unitary charter in the interim should be permitted to take advantage of the commercial loophole.

Federal Home Loan Banks

3. Federal Home Loan Bank Reforms. IBAA believes that any financial modernization bill must include provisions for meeting the funding and liquidity needs of institutions that serve local markets and communities, but don't have access to capital markets. The Federal Home Loan Bank System reform language in Chairman Leach's bill meets this test, and is a very positive feature for community banks and their customers. We further commend Chairman Leach and Representatives Baker and Kanjorski for their ongoing efforts in support of these essential provisions.

Community banks are under enormous competitive pressures for core deposits from mutual funds and other non-bank investment instruments. In light of the increased difficulties of attracting and maintaining their core deposit base, community banks need a reliable source of

funds to meet the credit demands of the communities they serve. Community banks need the type of long-term funds that the Federal Home Loan Bank System can provide to match long-term lending needs.

Thousands of community banks have joined a Federal Home Loan Bank, but others have been unable to do so because they cannot meet the current System membership test requiring at least ten percent of assets to be mortgage-related. Additionally, many community banks do not have sufficient eligible collateral to support the System's advance requirements. The language in Chairman Leach's bill, granting automatic eligibility to institutions with $500 million or less in assets and expanding the collateral base to pledge against advances to include agricultural and small business loans, would be an important step to long-term community bank viability.

Insurance Provisions

4. Non-Discriminatory Insurance Language. Any financial restructuring bill should include new retail powers for banks, including, within the parameters of safety and soundness, unrestricted insurance agency powers and the power to sell mutual funds and other financial products and services, including annuities. Such retail sales authority presents little risk and we see no reason why it shouldn't be exercised either though a holding company affiliate or an operating subsidiary of a bank.

In dealing with bank sales of insurance products, we believe that any roll back of an existing authority of banks, whether chartered at the federal or state level, is anti-competitive and would reduce choice for consumers. Regrettably, our most recent analysis of the insurance provisions in the Leach bill indicates that existing powers of community banks would indeed be rolled back, making it more difficult for them to enter into the insurance business in the future.

Additionally, Mr. Chairman, H.R. 10 would remove the judicial deference of the Comptroller of the Currency in interpreting the insurance sales authority of national banks under the National Bank Act, almost assuring a series of long and protracted court battles which are not in the interest of community banks.

With the Chairman's permission, I would like to insert a memo into the Record prepared by the law firm Bracewell & Patterson, summarizing and analyzing the insurance provisions in the Chairman's bill. Our outside general counsel is a member of this distinguished firm.

Protecting the Deposit Insurance Fund

5. Protecting the Federal Deposit Insurance Fund. Our future regulatory and supervisory structure must be designed to insure that the FDIC's deposit insurance funds are protected from being raided should a huge financial conglomerate collapse. At issue is the emergence of large financial conglomerates including, for example, a large commercial bank and a firm underwriting property and casualty insurance -- a very risky business. If the property and

casualty firm were to fail, it would be in the nation's foremost interest to protect banking and the American taxpayer, and to build in maximum insulation of the insurance firm from the federal safety net unique to banks, including deposit insurance. We are concerned that such insulation can never be complete.

In hearings on financial modernization last year, this Committee heard ample testimony questioning the efficacy of firewalls. Even Chairman Greenspan has warned against placing too much faith in firewalls, testifying before this Committee in 1995 that "under stress they tend to melt."

This being the case, it is crucial that there be maximum insulation of risky activities conducted in a financial conglomerate from the commercial bank component, in order to protect first the FDIC fund and then the American taxpayer. We support the language in Chairman Leach's bill that prohibits bank subsidiaries from engaging in activities or to own an interest in a company that engages in activities not permissible for national banks to engage in directly, such as insurance or securities underwriting, real estate investment activities, or merchant banking.

In a letter to IBAA last year, Chairman Greenspan wrote: "H.R. 10 would prohibit operating subsidiaries from engaging as principal in activities that are not permissible for the parent national bank, primarily insurance underwriting, securities underwriting and dealing, merchant banking, and real estate investment and development activities. In my opinion, H.R. 10 provides important protection to the deposit insurance fund from the risk of loss from these activities by requiring that these activities be conducted in a holding company rather than in a bank subsidiary and, thus, not with the support of the safety net." We agree with Chairman Greenspan.

The IBAA also believes that ongoing mergers and acquisitions are establishing too-big-to-fail entities presenting systemic risk to the financial system and the economy that future administrations and regulators will always bail out if they run into serious problems.

Umbrella Regulator

6. Role of the Federal Reserve. The IBAA strongly supports the establishment of an umbrella regulator for diversified financial services firms and feel the only federal regulator equipped for this job is the Federal Reserve. Chairman Leach's bill meets this important test, with the exception of the regulation and supervision of unitary thrift holding companies. A unitary with a commercial affiliate would be considered a diversified financial firm that would warrant Fed oversight because of its complexity and risk to the financial system.

Consumer Regulations

7. Insuring Even-Handed Consumer Regulations. IBAA believes that the level of regulation should be commensurate with the risk institutions present to the financial system and

the economy. Consumer protection regulation, in turn, should be even-handed and either lifted for all or applied to all, since it represents a competitive cost factor.

The Leach bill prescribes a series of consumer protections with regard to the sale of insurance by banks. This will represent a floor for the conduct of insurance activities by national banks, and will not preempt conflicting or more demanding state consumer protection laws or federal securities laws, unless the banking agencies conclude that their rules provide greater consumer protection. This is a continuing area of concern, and we urge state insurance regulators to adhere to even-handed consumer application under the law.

Woofies

In addition to these seven guiding principles, IBAA has identified several other areas of concern that we encourage this Committee to address, including the establishment in this bill of wholesale financial institutions, or "Woofies," which could jeopardize the exclusive access to the payments system by FDIC-insured institutions. Woofies, under this bill, would be able to access the Federal Reserve System's payment services and take uninsured deposits. The long term implications of this major policy shift have not been explored.

We also are concerned that the creation of Woofies opens up the potential for new, specialized charters that could be superior to a banking charter because they could be exempt from banking regulations. And very important from a public policy standpoint, since Woofies can also be owned by bank holding companies, wholesale deposits could be moved from the insured bank to the uninsured Woofies, which could narrow the deposit insurance fund base and lead to a de-stabilization of the deposit insurance funds.

Only one or two Wall Street firms want this Woofies provision -- we don't really know why -- and we ask the Committee to fully explore this new proposed bank charter before enacting it into law.

Conclusion

In conclusion, Mr. Chairman, we recognize the enormous commitment by you and others on this Committee which led to the near-passage of financial modernization legislation in the last Congress. IBAA policy bodies carefully reviewed the legislation at every stop along the way, and there were many. We commend you for building on the progress made last year.

We believe important and significant strides have been made over the last year, strides that led to a dramatic change in IBAA's position on financial modernization last Fall. We moved from a position of opposition to the bill that came to the House floor, to a position of no opposition to the bill that was reported out of the Senate Banking Committee to the Senate floor. We also actively supported moving the process forward to allow for full consideration of the bill on the Senate floor, noting that the bill is substantially the same as Chairman Leach's new H.R.

10. I would ask permission of the Chair at this point to insert in the Record a copy of a letter the IBAA sent to each member of the House Banking Committee on January 19, 1999, outlining our opposition to the bill that Rep. John LaFalce (D-NY) has introduced.

We would encourage the Committee to similarly move this process forward towards full House consideration of the Leach bill. IBAA's Policy Development Committee and Board of Directors will be meeting within the next month and a half to once again review our position on this legislation.

Mr. Chairman, we look forward to working with you and others on this committee to refine a product that can meet the principles that we have outlined in our testimony.

Thank you for the opportunity to testify today.

Attachment 1: Bracewell & Patterson, L.L.P., Memorandum re. Summary of Insurance Provisions, Financial Services Act of 1999 ("H.R. 10")

Attachment 2: January 19, 1999, letter from IBAA Executive Vice President Kenneth A. Guenther to Chairman Leach (Similar letter sent to all members of House Banking Committee)

BRACEWELL & PATTERSON, L.L.P.
A REGISTERED LIMITED LIABILITY PARTNERSHIP
ATTORNEYS AT LAW

MEMORANDUM

TO: Len Rubin

FROM: Sandy Brown
John Podvin, Jr.

DATE: January 26, 1999

RE: Summary of Insurance Provisions
Financial Services Act of 1999 ("H.R. 10")

Following is an analysis of the insurance provisions of H.R. 10 with respect to its impact on the ability of community banks to engage in the sale of insurance.

SHORT ANSWER

The insurance provisions of H.R. 10 are a rollback of the existing powers of community banks and will make it more difficult for them to enter into the insurance business in the future. Below, in bullet point format, is a section-by-section analysis of the insurance provisions of H.R. 10.

SECTION 104 - OPERATION OF STATE LAW

- Affiliations between banks and insurance companies may not be prevented or restricted by state law. However, state law may require detailed information specified in Section 104(a)(2) from any entity seeking such an affiliation. **This will substantially increase the already high regulatory burden on bank/insurance affiliations in a manner that would likely vary among the 50 states.**

- **The Barnett case is significantly undercut by Section 104(b)**, by preserving 13 separate areas where state law may impose discriminatory restrictions on bank insurance sales. This section would fundamentally change many years of legal decisions concerning the Comptroller of the Currency's interpretation of the National Bank Act and the Supreme Courts' interpretations of the supremacy clause and administrative law.

TITLE III - INSURANCE

SUBTITLE A - STATE REGULATION OF INSURANCE

- Section 303 **authorizes functional regulation by the States** concerning insurance sales activities by any person or entity in accordance with Section 104, which authorizes discriminatory state regulation for banks that wish to enter into the insurance sales business.

- Section 304 **limits national bank (including bank subsidiaries) underwriting of insurance to products authorized by the Comptroller of the Currency as of January 1, 1997**, that do not involve title insurance or annuity contracts and where no court of relevant jurisdiction had, by final judgment, overturned such determination by the Comptroller of the Currency that national banks may provide such a product as principal. Insurance is defined (for purposes of underwriting) to include any product regulated as insurance under state insurance law and includes annuity contracts.

- Section 305 **codifies the prohibition against national banks engaging in any activity involving underwriting of title insurance**, including activities conducted in a affiliate or subsidiary as defined in Section 2 of the Bank Holding Company Act of 1956.

- Section 306 creates a system for dispute resolution between state insurance regulators and federal regulators concerning whether a product is or is not insurance. Review of these disputes by courts shall be conducted "without unequal deference", which **undermines the deference to the Comptroller of the Currency developed through case law interpreting the National Bank Act, the Supremacy** Clause **and administrative law, as set forth most recently in the VALIC case.**

- Section 307 **effectively codifies the Interagency Statement for Retail** Sales of **Nondeposit Investment Products**. This is accomplished by adding a section to the Federal Deposit Insurance Act that would require any insured depository institution to comply with the restrictions in this bill and with consumer protection regulations jointly issued by the Federal agencies implementing this section. These regulations also are extended to any subsidiaries of an insured depository institution but not to affiliates, such as a bank holding company subsidiary. In addition, the regulations

adopted by the Federal banking agencies under Section 307 will only preempt State consumer protection laws if the State law in question is less stingiest in terms of consumer protection than the Federal regulations.

- Violation of the insurance provisions contained in the safe harbor under Section 104 and of the Consumer Protection Provisions in Section 307 **could subject banks to private lawsuits, including class actions**, in addition to regulatory enforcement actions brought by banking and insurance regulatory agencies. Finally, Section 307 would likely **add tremendous amounts of discriminatory regulatory burden on the banking industry**.

The bottom line is we believe that these insurance provisions would effectively preclude most community banks from engaging in the agency sale of insurance and annuities products. Furthermore, we are very concerned about the precedent that H.R. 10 establishes in removing deference to the Comptroller in interpreting the National Bank Act. In addition, H.R. 10 essentially forces all insurance activities to be conducted in a holding company subsidiary, which may make it more difficult for some community banks to engage in insurance-related activities. Finally, if H.R. 10 is passed in its present form, the complicated structure that it establishes will provide a great deal of litigation which is not in the best interest of community banks.

SMB
FJP

IBAA
INDEPENDENT BANKERS
ASSOCIATION OF AMERICA

January 19, 1999

Honorable Jim Leach
Chairman
House Banking and Financial Services Committee
U.S. House of Representative
Washington, D.C. 20515

Dear Chairman Leach:

Last Fall, the banker leadership of the Independent Bankers Association of America (IBAA) supported full Senate consideration of the D'Amato-Sarbanes version of H.R. 10, the Financial Services Act of 1998. In taking this position, we recognized that significant strides had been made to address the concerns of not only the banking industry, but also the interests of community banks. The bill contained a number of hard-fought compromises that led to the historic, but lost, opportunity last Fall to pass legislation that was not opposed by any major sector of the financial services industry.

We applaud Chairman Leach for introducing substantially similar legislation in the new Congress, negating the unappealing prospect of re-waging old battles and re-negotiating existing compromises. We also commend Chairman Gramm for his constructive comments to move this process forward in an expeditious manner in the Senate.

Regrettably, the draft financial modernization proposal being circulated by Rep. John LaFalce (D-NY) moves in the opposite direction, is counter-productive to the process, and we must strongly oppose it.

Last Fall, the IBAA identified several guiding principles that we felt must be embodied in any financial modernization proposal. These principles included:

- Closing the unitary thrift holding company loophole.
- Providing non-discriminatory insurance language.
- Insuring even-handed consumer regulations.
- Pushing out new risky financial activities to holding company affiliates.
- Preserving the Federal Reserve as the umbrella regulator of new financial services holding companies.
- Protecting the Federal Deposit Insurance Fund.
- Providing easier access to alternative liquidity sources for community banks.
- And maintaining the separation of banking and commerce.

The version of H.R. 10 reported out of the Senate Banking Committee last Fall substantially addressed these principles, as does the bill introduced in the 106th Congress by

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Chairman Leach. Unfortunately, the version being circulated by Congressman LaFalce fails this test in several important ways:

- First, it reintroduces the concept of a commercial basket by permitting a bank holding company to own a commercial firm provided the annual gross revenues from the commercial activities do not exceed 15 percent of the holding company's consolidated annual gross revenues, and the commercial assets do not exceed $750 million at the time the commercial shares are acquired. This clearly takes this bill out of the "narrow bill" realm, and would encourage financial institutions to engage in the kind of crony capitalism that has undermined the economies of Japan, Brazil and a number of Assian nations. The case against the mixing of banking and commerce is well established. Both Federal Reserve Board Chairman Alan Greenspan and Treasury Secretary Robert Rubin have raised serious concerns about moving in this direction at this time. Moreover, the House last year voted to remove the commercial basket from H.R. 10, and this action was not overturned, or even debated, by the Senate Banking Committee. Now is not the time to open the door to commercial bank ownership of commercial firms. Chairman Leach has often and wisely pointed out that opening the door for commercial bank ownership of commercial firms will lead to demands that commercial firms be allowed to own banks -- the reserve basket. This is a path the United States should not get on.

- Second, the LaFalce draft does not close the unitary thrift holding company loophole, perpetuating the opportunity for commercial firms to own thrifts, and for thrifts to own commercial firms. This loophole is of major concern to Chairman Greenspan, and in his testimony before the Senate Banking Committee late last year, Treasury Secretary Rubin expressed his concern as well. Last year, both ABA and the IBAA made closing this loophole an absolute pre-requisite for support of any financial modernization bill. Our position has not changed. This loophole permits the breaching of the banking and commerce wall, jeopardizing the impartial allocation of credit and stretching the deposit insurance safety net beyond its intended purpose.

- Third, the LaFalce proposal does not contain Federal Home Loan Bank System reforms which IBAA believes is vital to the long-term viability of community banks. The Federal Home Loan Bank System is an important source of liquidity for community banks which face growing competition from government-subsidized lenders such as credit unions and Farm Credit associations. IBAA strongly supports the FHLBank provision in H.R. 10 that provides for automatic membership eligibility for financial institutions with $500 million or less in assets and expands the collateral that can be pledged against advances to include agricultural and small business loans. This provision is especially important to our nation's agricultural banks to help America's farmers through the increasingly grave farm crisis.

- Fourth, the LaFalce draft contains new consumer regulations and disclosure requirements that would impose onerous new hardships on community banks, already burdened by the disproportionate cost of CRA compliance. We do not believe this new language meets the test of "even handed consumer regulations."

We urge you to not abandon the substantial progress that was made last year in the development of a financial modernization bill that addressed, in at least some degree, the concerns of all sectors of the financial services industry. As you know, the bill that came to the House floor last year was vehemently opposed by almost all sectors of the banking industry and passed the House by only one vote. This need not happen again. The LaFalce proposal re-opens old wounds, re-surfaces the differences among the banking, insurance and securities industries, and doesn't in any way address the outstanding differences between Chairman Greenspan and Secretary Rubin.

Sincerely,

K

Kenneth A. Guenther
Executive Vice President

Testimony

of

America's Community Bankers

on the

"Financial Services Act of 1999"

before the

Committee on Banking and Financial Services

of the

U.S. House of Representatives

on

February 10, 1999

E. Lee Beard
President and CEO
First Federal Bank
Hazleton, PA

and

Chair
America's Community Bankers
Washington, DC

Mr. Chairman and Members of the Committee, I am E. Lee Beard, President of First Federal Bank in Hazleton, Pennsylvania. First Federal Bank is a $520 million asset institution held by a unitary savings and loan holding company. Until recently, our institution – like hundreds of others – was in mutual form.

I am here today in my capacity as chair of America's Community Bankers, which represents progressive community bankers across the nation. ACB is the national trade association for 2,000 savings and community financial institutions and related business firms. The industry has more than $1 trillion in assets, 250,000 employees, and 15,000 offices. ACB members have diverse business strategies based on consumer financial services, housing finance, small business lending, and community development.

Mr. Chairman, ACB appreciates this opportunity to testify on your committee's priority issue, financial modernization. ACB shares your hope, stated in your letter of invitation, that the 106th Congress can agree "on legislation to provide a framework where the banking, securities, and insurance industries compete at an optimal level of efficiency and effectiveness while providing consumers access to the broadest possible range of financial services and products." This statement recognizes that it is not government that will be modernizing the financial system. It is the system itself, businesses, consumers, and communities that are adapting to new circumstances. It is the government's role "to provide a framework" to allow that process to continue without unnecessary impediment.

ACB urges that this legislation give consumers and the financial industry the greatest possible range of choices. The 105th Congress made substantial progress toward meaningful financial modernization and we appreciate your willingness to continue its work. Recognizing that you are building on an existing system, not starting from scratch, ACB believes that your legislation should seek to improve existing charters and holding company structures without reducing any competitive options and consumer choices.

ACB's diverse membership makes full use of all the choices already available. We represent institutions with both state and federal charters; hundreds are owned by stockholders; and hundreds are in mutual form. ACB is proud to represent nationally known new corporate entrants from the insurance and securities industries. At the same time, we assist newly converted mutuals from the credit union industry. My own institution recently converted to stock ownership and changed its name from First Federal Savings and Loan Association to First Federal Bank. We also organized a unitary thrift holding company to expand our business options. Our board decided to convert after carefully evaluating our market and our customers' needs, and deciding that a new direction would be the best way to continue to grow and serve our community.

Our bank's choice is not necessarily the right one for all savings institutions; each should have a full range of choices to meet the needs of <u>their</u> customers and communities. That is why ACB urges Congress to <u>expand</u> choices for the financial industry, <u>not</u> reduce them. Much of the value of our bank is based on its assets, capital, and current structure, but another component is what our charter allows us to do. This value is there whether or not we

are actually engaged in a particular activity. Eliminating a potential activity would adversely affect our value. When we chose to convert from mutual to a unitary holding company structure, we based our decision on what was best for our business, our customers, and our community. We could have chosen to remain in mutual form, convert to a national or state bank or the route we selected. Financial modernization legislation should not limit in any way the options available to any of us in the financial services industry.

We Are Moving Toward a Financial Services Industry

Mr. Chairman, your letter of invitation recognizes that "technology, mergers, regulatory changes and international competition have altered the face of the financial services industry...." This implicitly acknowledges that we are dealing with one industry - the financial industry - not a host of competing industries that must be protected from one another. If it starts from this premise, Congress can avoid being a referee between segments of the industry. Instead, Congress can focus on making sound public policy decisions and setting essential rules of the road, such as safety and soundness requirements and investor protections. Businesses and customers can determine for themselves what services they will offer and buy.

My customers already understand that there is a single financial industry. They never ask if we are a thrift or a bank. They simply ask what products and services we provide, at what cost, at what level of risk (such as, are the products insured or not), and do we offer good service. If First Federal Bank can provide the full range of services and meet the needs of our customers, we and our communities can prosper. This committee's goal should be to let us keep the flexibility we already have and increase it as much as possible.

Fortunately, there are already examples in today's financial system that provide a road map for positive legislation. The first example is provided from my own part of the industry: thrifts and the thrift holding company structure. The second example is the nation's mutual funds. Each of these financial delivery structures can be used by a diverse array of firms to serve their customers.

Let me explain how this works in practice. For years, securities, insurance, and non-financial holding companies and bank holding companies have owned savings associations. These thrifts - generally operated as traditional housing and consumer lenders - have given their holding companies the ability to offer an important array of financial services to their customers.

Recently, a number of additional firms have applied for thrift charters. The intent of these diversified firms are consistent with long-standing precedent, although their relative numbers are now higher. The Office of Thrift Supervision (OTS) has carefully reviewed each of these applications to satisfy itself that they present viable business plans and that the thrifts will comply with all applicable safety and soundness, consumer, and community reinvestment laws. Where these applications are approved, the OTS will carefully supervise the

transactions between the thrift and its holding company to ensure that the they are on an appropriate arms-length basis.

The OTS does not generally seek to regulate the capital and activities of the holding companies themselves. Regulated firms, such as securities and insurance companies, are already regulated by their functional regulators. Publicly held holding companies are also regulated by the toughest financial regulator of all: the marketplace. Every day, these firms must demonstrate to their owners that their earnings and business prospects justify their continued confidence.

Mutual funds provide another example for a more flexible financial system. In recent years, many types of financial firms, including banks and thrifts, have become involved in the mutual fund sector. It is neither a question of a bank, thrift or some other company "getting into" the mutual fund business, nor one of a mutual fund "getting into" banking or "getting into" insurance. Mutual funds, like thrift products, are simply another financial service and delivery channel a firm may offer to its customers. Of course, every mutual fund, like every thrift, must meet strict statutory and regulatory requirements, regardless of its affiliation. Like those parts of the thrift industry affiliated with diverse firms, mutual funds with connections to other types of firms have compiled an exemplary record of service to the public.

The Need for Financial Modernization

While parts of the financial industry - thrifts and mutual funds, for example - can already participate in the evolving modernized structure, commercial banks and bank holding companies (BHCs) have been left behind in some respects. They face significant limitations on their ability to offer financial services beyond what has traditionally been called banking. The Glass-Steagall Act hampers affiliations between the banking and securities industries. Although the Federal Reserve has loosened Glass-Steagall substantially, the law remains an anti-competitive anachronism. Bank holding companies may only acquire securities firms that fit within arbitrary size limits, while major securities firms are unable to acquire banks.

In a similar vein, the Bank Holding Company (BHC) Act does not permit banks to affiliate with insurance underwriting companies. Beyond that, the BHC Act limits banks to affiliations with firms "closely related" to banking. Banks that wish to sell insurance products face a patchwork of state and federal statutes, as well as court and agency interpretations that sometimes permit and sometimes prohibit insurance activities.

Congress should not change these laws merely for the convenience and profit of the banking sector. It should change them to improve economic efficiency and competition. Despite their loss of market share, commercial banks remain a vital source of credit to businesses and consumers. And, the Federal Reserve conducts much of the nation's monetary policy through its links to major commercial banks. A shrinking and inefficient commercial banking sector is bad for business, consumers, and the economy. Congress can correct much of the problem by adding options to the bank charter and bank holding company structure.

H.R. 10 would make substantial improvements, particularly by permitting banks to freely affiliate with securities and insurance firms at the holding company level. As Representative David Dreier demonstrated with legislation he introduced in the 105th Congress, these major improvement can be accomplished in just a few sections of legislative language. This year, Rep. John LaFalce is working on similar legislation that – like the Dreier bill – avoids cutting back on charter options that are important to institutions.

These proposals demonstrate that financial modernization legislation need not – as it should not – damage those features of the bank charter that are already modernized. The Comptroller of the Currency's (OCC) Part 5 rule gives national banks the opportunity to apply to offer a full range of financial services through operating subsidiaries. H.R. 10 would prohibit those subsidiaries – no matter how insulated from risk – from fully utilizing Part 5. As a result, some key activities could be done only through a holding company structure. In addition to imposing an unnecessary limitation, this would eliminate an opportunity to strengthen the national banking system. While this would most directly affect existing national banks, this backward step would eliminate an important option and model for the entire financial industry.

The Federal Reserve and others are concerned that, if banks are permitted to offer new financial services through their subsidiaries they will use that form of organization exclusively. My own bank's experience demonstrates that these fears are not well founded. We elected to operate within a unitary thrift holding company for a variety of reasons, including the opportunity to establish holding company affiliates which can provide services outside of the bank's customer base, with no risk to the bank's capital, and with a different name from the bank. For instance, we have a subsidiary of the bank (FIDACO) which has an investment in the Hazleton Community Development Corporation (HCDC). HCDC was established in 1991 as a for-profit community development organization designed to promote economic improvements within the city of Hazleton, Pennsylvania.

The key point is, we made these choices – holding company affiliate or bank subsidiary – for business reasons, not to comply with regulatory requirements. I am sure that national banks and their holding companies will made the same sort of choices if you let them keep their current options under the OCC's Part 5.

The OCC has also successfully increased the ability of national banks to offer insurance services and annuities to their customers. H.R. 10 attempts to draw lines between state and federal control over banks' insurance sales. This language has dramatically increased in scope and complexity as it moved through the 105th Congress. ACB is concerned that these provisions are internally inconsistent, rather than being carefully balanced. It could take years of litigation to sort them out. In the meantime, consumers could be denied competitive and efficient insurance services.

This language is apparently intended to diminish fears that the OCC will engage in a wave of unwarranted preemptions of state insurance laws. Based on the history of the OCC since the 1860s, such fears are groundless. The limited preemptions approved by the OCC

have been upheld by the Supreme Court in a series of 9 to 0 decisions. The OCC's actions have increased competition and customer service and have harmed no one. The current system is not broken. Current law has achieved a balance of state and federal jurisdiction that best protects and advances consumer interests.

A few of ACB members operate with a national bank charter, and its health is important to us for a number of additional reasons. Most directly, Federal thrifts and state-chartered banks may generally only offer as principal those products and services permissible for national banks (agency activities are not covered by this limitation). More broadly, as national banks gained the flexibility to offer insurance services, states have extended that flexibility to their own banks and removed restrictions on state chartered savings banks. Finally, a strong national bank charter could benefit many firms, including thrift holding companies. For example, Citigroup operates both a national bank and a federal savings bank, using those charters where they make the most business sense. Congress should allow both charters to retain their flexibility and enhance it wherever possible.

The Value of the Thrift Charter Unitary Holding Company Structure

Although H.R. 10 both increases and reduces the competitive flexibility of banks and bank holding companies in various dimensions, H.R. 10 unfortunately goes in just one direction for thrifts and their holding companies - backwards. It would limit new unitary thrift holding companies to strictly financial activities and prevent existing unitaries with commercial activities from changing ownership.

This is most certainly not an issue that concerns just a handful of big companies trying to "get into banking" through the thrift charter. There is no better example than my own bank. We determined that organizing as a unitary thrift holding company was our best business option. That is why First Federal joined the list of about 875 unitaries in the financial industry. We do not know all of the services our customers and communities will need in the future; market needs cannot be predicted. But, without the flexibility and adaptability of the unitary structure it would be impossible for First Federal and the other unitaries to serve changing customer needs without coming to Washington every time we want to offer a new product.

Our holding company already operates a title insurance agency that provides title searches and real estate settlement services in northeast Pennsylvania. The firm, Abstractors Inc., provides services for customers of First Federal Bank and receives customer referrals from other banks and finance companies. We are also seeking a state license to offer trust services through another holding company subsidiary, Hazleton Bancorp. It is very important to my bank and its community to retain the flexibility that we have under current law.

Another key element of the thrift charter is that it is available to any firm that has the financial and managerial strength to qualify. As we have seen, a diverse array of firms have applied for and obtained thrift charters. But, a bank holding company may also operate a thrift, and, a bank itself may convert to a thrift charter. For example, Citigroup does much of

its "banking" outside of New York through a thrift. Similarly, a commercial bank in Iowa converted to a thrift and is now opening branches in its parent holding company's grocery stores.

In exercising these choices, there are logical tradeoffs involved. For the unlimited commercial lending authority provided by the banking charter, an institution cannot affiliate with commercial firms. For the affiliation rights provided by the thrift charter, an institution must strictly limit its commercial lending, among other limitations of the Qualified Thrift Lender Test. The decision is theirs to make. Consumers, businesses, and communities all benefit from the diversity of services that results from these individual decisions.

Homebuyers are one major beneficiary. Thrifts maintain a high percentage of their assets in mortgage loans and related securities – 73.7% for thrifts owned by non-banking companies, 70.6% for thrifts as a whole. By contrast, banks have only 32.6% of their assets in mortgage loans and related securities. The National Association of Home Builders and the National Association of Realtors have pointed out that, "thrifts have demonstrated a pattern of ... serving low- and moderate-income borrowers. In many markets, thrifts are the leading source of residential construction and development loans." (joint letter, June 12, 1997)

The recent applications from diverse financial firms provide a marketplace validation of the value of the thrift charter and holding company structure. The financial strength of today's thrift industry, reflected by record profits, record capital levels, and a fully funded deposit insurance fund, is a testament to the flexibility and effective business options the thrift charter provides.

H.R. 10 Harms the Thrift Charter and Holding Company

Given the record of the thrift charter and holding company structure, Congress should hold it up as a model for modernization. Unfortunately, H.R. 10 would take away many of the unitary thrift holding company affiliation rights for companies that had not applied for a charter by October 7, 1998. Some of those firms might be satisfied with the improvements in the bank holding company structure provided in H.R. 10. Others might not, and some of the applicants would not qualify for a bank charter. There is no reason to cut off this successful, market-tested business option as of October 7, 1998 or any other arbitrary date.

H.R. 10 would also prohibit existing thrift holding companies with non-financial affiliates from merging with other firms. The only exception to this proposed statutory merger ban would allow mergers among the limited number of grandfathered thrift holding companies with non-financial affiliates. All other firms – financial firms and non-grandfathered commercial firms – would be barred by law from acquiring a grandfathered unitary thrift.

These artificial constraints on mergers, acquisitions, and divestitures would decrease the franchise value of existing holding companies and reduce economic efficiency without any substantive public policy justification. Prospective thrift holding companies would also lose business options because of newly imposed limitations.

Critics justify these limits by citing their concerns about mixing banking and commerce. We do not share these concerns. But, regardless of one's position on this issue, policy makers should understand that unitary thrift holding companies do not mix banking and commerce in any meaningful manner. Thrifts may not lend to commercial affiliates under any circumstances. And, thrifts' permissible commercial lending is strictly limited to 20 percent of assets, half of which must be small business loans.

H.R. 10 Undermines Uniform Federal Standards

One of the strongest features of the current thrift charter is the ability to offer traditional banking services - lending and deposit taking - under uniform Federal standards. This allows thrifts to offer efficiently a diverse array of products to all of their customers, regardless of where they live. The Office of Thrift Supervision (OTS) has enabled thrifts to offer this benefit to consumers by following Congress's directive to set uniform standards for these traditional services. The Supreme Court has fully endorsed these long-standing rulings, and they have not been a source of controversy.

One important reason for the lack of controversy is that the OTS has interpreted its preemption authority in a responsible and restrained manner. In recent years, OTS published and sought comment on the standards they would use in setting uniform standards for lending (1996) and deposit taking (1997). Unfortunately, H.R. 10 would impose an additional burdensome notice-and-comment process whenever the OTS seeks to implement these carefully considered standards. This additional procedure would have a chilling effect on Federal thrift operations, hamper the further development of a nationally competitive financial services marketplace, and increase costs and reduce convenience for consumers.

It would also hamper savings institutions' ability to respond to new competitive opportunities in electronic banking and Internet-based services. This area is evolving quickly, so the OTS cannot anticipate whether it will need to provide for uniform standards in it. However, it may have to move quickly, and a lengthy notice-and-comment procedure - which could last a year or more - could damage savings associations' ability to compete and serve their customers.

Even if the Congress does not impose a new procedural hurdle on Federal thrifts and the OTS, the agency is likely to operate with continued restraint. On a number of occasions, the OTS has been asked to preempt a state law and has declined to do so.

In summary, this new provision in H.R. 10 is harmful, redundant, and unnecessary. ACB urges you to strike it from the bill.

Thrifts and Thrift Holding Companies Already Subject to Strict Regulation

Congress can be confident that that if it leaves the thrift charter, unitary holding company structure, and regulatory system in place, thrifts will continue to be vigorously regulated. The OTS and the Federal Deposit Insurance Corporation impose the same tough capital and examination standards on thrifts as those imposed on commercial banks. Protection of thrifts and banks operating in holding company structures is equally as vigorous. In some cases, thrift regulation imposes special requirements; for example, thrifts may not make any loan to an affiliate engaged in activities prohibited for bank holding companies.

While undergoing vigorous supervision, combinations of thrifts and commercial firms have added demonstrably to the stability of the thrifts involved. They have compiled an exemplary safety and soundness record. The OTS reported that only 0.3 percent of enforcement actions against thrifts and thrift holding companies from January 1, 1993 through June 30, 1997 were against holding companies engaged in non-banking activities. In short, the industry's experience with well segregated commercial affiliates has been the opposite of what the critics contend.

Indeed, major firms have injected billions of dollars in capital into the thrift industry, providing an added level of stability. The OTS is careful to ensure that all transactions between thrifts and their diversified holding companies comply fully with the law - primarily sections 23A and 23B of the Federal Reserve Act - and otherwise do no harm to the thrift itself.

A Note on SAIF Special Reserve & FHLBank Modernization

H.R. 10 is similar to the version reported by the Senate Banking Committee last year and, as such, includes welcome provisions to repeal the SAIF special reserve and to modernize the Federal Home Loan Bank System. Repealing the special reserve will give the FDIC needed flexibility in administering the Savings Association Insurance Fund, while the FHLBank language will equalize membership terms and put the System's payment of its RefCorp obligation on a more businesslike footing. While ACB supports the inclusion of these important provisions in any viable legislative vehicle, we believe that they should be also considered on their own merits.

Conclusion

ACB urges the Committee to rethink its approach to financial modernization and write a bill that would provide new competitive options for financial firms without reducing or eliminating firms' ability to provide competitive products and services. I hope that as this debate moves forward, all elements of the financial industry will view what flexibility you find in current law as an opportunity, rather than a threat. This approach will help Congress make a major step forward for the financial system and, more importantly, for the customers and communities it serves.

STATEMENT OF MATTHEW P. FINK

PRESIDENT

INVESTMENT COMPANY INSTITUTE

BEFORE THE

COMMITTEE ON BANKING AND FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

ON

THE "FINANCIAL SERVICES ACT OF 1999"

H.R. 10

FEBRUARY 10, 1999

I. Introduction

My name is Matthew P. Fink. I am President of the Investment Company Institute, the national association of the American investment company industry. The Institute's membership includes 7,408 open-end investment companies ("mutual funds"), 449 closed-end investment companies and 8 sponsors of unit investment trusts. The Institute's mutual fund members have assets of about $5.468 trillion, accounting for approximately 95 percent of total industry assets, and have over 62 million individual shareholders. The Institute's members include mutual funds advised by investment counseling firms, broker-dealers, insurance companies, bank holding companies, banks, savings associations, and affiliates of commercial firms.

Mr. Chairman and Members of the Committee, I am pleased to be here today on behalf of the Institute to testify in support of H.R. 10, the "Financial Services Act of 1999" and thank you for the opportunity to express our views on this legislation. The Institute has been an active participant in the debate on financial services reform and has testified before Congress on subjects directly related to financial services reform numerous times over the last twenty-three years.

Initially, we would like to commend your leadership in spearheading the effort for financial services reform legislation. To most observers, it is now abundantly clear that the laws that separate mutual funds, banks, broker-dealers, insurance companies, and other financial services firms are obsolete in the face of technological advances, fierce competition, and dynamic and evolving capital and financial markets.

In light of the evolution of H.R. 10 since its initial introduction, the legislation now reflects a sound framework for reform of the financial services industry. Thus, we would urge Congress to enact H.R. 10. As is discussed further below, we also believe that certain changes should be made to the bill as the process moves forward. The Institute anticipates that these matters will be satisfactorily resolved through reasonable compromise, and we fully support passage of this legislation.

II. Background

A. Regulation of the Mutual Fund Industry

Since 1940, when Congress enacted the Investment Company Act, the mutual fund industry has grown steadily from 68 funds to over 7,000 funds today, and from assets of $448 million in 1940 to over $5 trillion today. In our view, the most important factor contributing to the mutual fund industry's growth and success is that mutual funds are subject to stringent regulation by the Securities and Exchange Commission under the Investment Company Act. The core objectives of the Act are to: (1) ensure that investors receive adequate, accurate information about mutual funds in which they invest; (2) protect the integrity of the fund's assets; (3) prohibit abusive forms of self-dealing; (4) restrict unfair and unsound capital structures; and (5) ensure the fair valuation of investor purchases and redemptions. These requirements—and the industry's commitment to complying with their letter and spirit—have produced widespread public confidence in the mutual fund industry. In our judgment, this investor confidence has been and continues to be the foundation for the success that the industry enjoys.

Our opinion concerning the efficacy of the mutual fund regulatory system has been corroborated by the General Accounting Office. In its report on mutual fund regulation, it found that "the SEC has responded to the challenges presented by growth in the mutual fund industry." It also noted that the "SEC's oversight focuses on protecting mutual fund investors by minimizing the risk to investors from fraud, mismanagement, conflicts of interest, and misleading or incomplete disclosure." To carry out its oversight goal, the SEC performs on-site inspections, reviews disclosure documents, engages in regulatory activities, and takes enforcement actions. The SEC is also buttressed by "industry support for strict compliance with securities laws."[1]

The mutual fund industry has always spoken out against developments that would impair this effective and time-tested regulatory system, such as would occur if the supervisory approaches applied to banks were imposed on the mutual fund industry.

B. Differences Between Bank Regulation and Mutual Fund Regulation

H.R. 10 recognizes that if financial services reform is to succeed in producing more vibrant and competitive financial services companies, it *must* provide a regulatory structure that respects and is carefully tailored to the divergent requirements of each of the business sectors that comprise the financial services marketplace. The mutual fund, broker-dealer, banking, and insurance industries all historically have been and presently are subject to extensive governmental oversight. But for reasons that continue to make good sense even in this era of

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[1] Mutual Funds: SEC Adjusted its Oversight in Response to Rapid Industry Growth (GAO/GGD-97-67, May 28, 1997) at pages 28, 5 & 29, respectively.

consolidation and conglomeration, the regulations governing each of these businesses rest on different premises, have different public policy objectives, and respond to distinct governmental and societal concerns.

Our securities markets are based on transparency, strict market discipline, creativity and risk-taking. The federal securities laws, including the Investment Company Act, reflect the nature of this marketplace and, accordingly, do not seek to limit risk-taking nor do they extend any governmental guarantee. Rather, the securities laws require full and fair disclosure of all material information, focus on protecting investors and maintaining fair and orderly markets, and prohibit fraudulent and deceptive practices. Securities regulators strictly enforce the securities laws by bringing enforcement actions, and imposing substantial penalties—in a process that by design is fully disclosed to the markets and the American public.

Banks, by contrast, are supported by federal deposit insurance, access to the discount window and the payments system, and the overall federal safety net. For these reasons, banking regulation imposes significant restraints and requirements on the operation of banks.

It may well be that this regulatory approach is prudent and appropriate when it comes to the government's interest in overseeing banks. But it would be fundamentally inconsistent with the very nature of the securities markets to impose bank-like regulation on mutual fund companies and other securities firms. To do so could profoundly impair the ability of mutual funds and securities firms to serve their customers and compete effectively. More worrisome, it could compromise the continued successful operation of the existing securities regulatory system.

Finally—and perhaps most importantly—imposing bank-like regulation on an industry for which it was not designed could even jeopardize the functioning of our broad capital markets. This would risk the loss of a priceless and valuable national asset. As SEC Chairman Arthur Levitt has stated, "[o]ur capital markets must remain among our nation's most spectacular achievements . . . . Those markets, and investors' confidence in them, are a rich legacy we have inherited, but do not own. They are a national asset we hold in trust for our children, and for generations of Americans to come."[2] This Committee is wise to ensure that otherwise well-intended efforts to modernize financial services law and regulation do not compromise our capital formation system.

III. The Elements of Successful Financial Services Reform

By permitting affiliations among all types of financial companies, H.R. 10 represents a major step forward in the effort to modernize the nation's financial laws and to realign the financial services industry in a manner that should benefit the economy and the public. It also includes three important principles that underlie successful financial services reform: (1) it would grant banking organizations full mutual fund powers; (2) it would modernize the federal securities laws to address bank-mutual fund activities; and (3) it would establish an oversight system based on functional regulation.

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2 "A Declaration of (Accounting) Independence," Remarks by Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, before The Conference Board, New York, New York (Oct. 8, 1997).

In light of our support of H.R. 10, we would like to take this opportunity to call to your attention certain changes we believe should be made to the bill as it moves forward. These changes pertain to: (1) the appropriate role of the bank regulatory agencies; (2) nonfinancial activities for diversified financial services organizations; and (3) the grandfather date for unitary savings and loan holding companies.

IV. The Appropriate Role of the Bank Regulatory Agencies

Federal Reserve Board. Under H.R. 10, the Federal Reserve Board would be assigned regulatory responsibility over all financial holding companies, including any financial services organization that owns a bank. The Institute has testified previously regarding our belief that it is unnecessary to assign to the Federal Reserve this type of "umbrella regulator" role, but we acknowledge that H.R. 10 would address many of our concerns as it would limit any authority the Board otherwise might have over the operations of the holding company's regulated subsidiaries. In particular, the Board could only exercise such authority if necessary to prevent a material risk to the financial safety and stability of an affiliated bank or the payments system.

In adopting this approach, H.R. 10 recognizes the need to adjust the present statutory authority of the banking agencies. This adjustment is needed because the statutory schemes applicable to these agencies did not envision that a supervised bank might be affiliated with several functionally-regulated, non-bank entities like mutual fund companies, broker-dealers, or insurance companies. Accordingly, laws that provide for banking agency supervisory authority over bank affiliates in general have not taken the role and responsibility of other functional regulators into account.

The Board has indicated that the standards imposed under H.R. 10 would be sufficient to maintain the safety and soundness of our financial system in general and the banking system in particular[3] and that they would provide a method for the Board "to enforce compliance by the organization with the Federal banking laws."[4] For example, they would not affect the applicability of H.R. 10's specific provisions that require adoption of consumer regulations for banks and their subsidiaries. Thus, in general, with respect to the role of the Board, H.R. 10 strikes an appropriate balance between preserving the Board's authority to protect the safety and soundness of the banking, financial and payments systems and avoiding the potential for supervisory intervention into a regulated non-bank entity's day-to-day affairs.

Role of Bank Primary Supervisors. Similar to the Federal Reserve, the other banking agencies are responsible for supervising banks to protect the deposit insurance funds and to enforce the banking laws. For the very same reasons discussed above, these agencies should have no greater authority than, and should be subject to the same standards as, the Federal Reserve Board with respect to the ability to exercise supervisory discretion over a functionally-regulated, non-bank entity.

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[3] *See generally Hearings before the Senate Committee on Banking, Housing and Urban Affairs on H.R. 10, the Financial Services Act of 1998*, Written Statement of Alan Greenspan, Chairman of the Board of Governors of the Federal Reserve System on H.R. 10 at 5 & 13-15.

[4] *Id.* at 15.

H.R. 10 applies these same functional regulation standards to the FDIC, with an exception for examinations where necessary to protect the deposit insurance funds.[5] However, H.R. 10 currently does not apply these standards to the Office of the Comptroller of the Currency (OCC) and the Office of Thrift Supervision (OTS). Thus, as presently constituted, H.R. 10 would not preclude these agencies from asserting that they have broad authority over bank affiliates—even those, like securities firms, that are subject to comprehensive regulation under a separate statutory scheme. Ironically, this could result in these banking agencies asserting that their authority is broader than that considered necessary by the Federal Reserve, the consolidated supervisor of financial holding companies, and the FDIC, the protector of the deposit insurance funds.

This is simply illogical, untenable and, we believe, unintended. The provisions in H.R. 10 that clarify the Federal Reserve's and the FDIC's authority with respect to functionally-regulated non-bank entities should also apply to the other banking agencies. In fact, the failure to do so is inconsistent with the otherwise carefully balanced structure and approach taken in H.R. 10. And this is not just an issue for mutual funds—it affects any functionally-regulated affiliate, including broker-dealers, investment advisers and insurance companies.

Let me give an example of how the failure to subject the OCC and the OTS to appropriate standards could result in duplicative or inconsistent regulation being imposed on bank affiliates. If information disclosed in a mutual fund prospectus was alleged to be misleading and some of

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[5] *See* Section 118 of H.R. 10.

the fund's shareholders were customers of affiliated banks, the banking agencies might attempt to argue that—in addition to the SEC—they should be empowered to take supervisory action against the mutual fund in order to prevent the harm to the mutual fund's reputation from spilling over and harming the reputation of the bank.

As a result, the mutual fund could be faced with a multitude of regulators asserting jurisdiction over the same event to prevent the spread of such a "risk" to its bank affiliates, *on top* of any potential action by the SEC under the securities laws to protect the fund and its shareholders. This is incompatible with the concept of functional regulation and would result in conflicting, inconsistent and overly burdensome regulation. It would also allow a banking agency to set aside the SEC's supervisory approach as well as its sense of judgment and materiality.

A simple reversal of the scenario reveals the absurdity of this approach. If a bank were allegedly not in compliance with consumer lending laws, would it make sense for the SEC to be able to take supervisory action against the bank? Would the SEC be justified in taking such action to ward off the contagion effect from the bank's "reputational risk" to its affiliated mutual fund? The questions answer themselves.

Unfortunately, scenarios like the one I posited are not merely theoretical concerns. History demonstrates that, pursuant to their statutes and regulations, the bank regulators *have* asserted authority over securities affiliates or subsidiaries of banks and *have* imposed requirements that are inconsistent with fundamental tenets of securities regulation. For example,

under the FDIC's rules related to state nonmember bank securities affiliates, the mix of securities that such a securities firm may underwrite have been restricted.[6] The FDIC rule's accompanying release indicated that its purpose was to address the risk associated with the proposed securities activities. It also indicated that, on a case-by-case basis, the FDIC would take action to prohibit particular practices, acts or conduct of the securities firm that it considered risky or unsafe or unsound. Likewise, if the OCC determines that a national bank may be affected by the risky nature of the operations of a subsidiary such as a securities firm, the OCC may direct the securities firm to discontinue specified activities or to be liquidated or divested.[7]

The concern also exists that a banking agency might be tempted to stifle innovation and preclude new product developments by a securities firm affiliated with a bank on the grounds that such developments may compromise the competitive standing of banks. For example, Professor John C. Coffee, Jr. observed that a single financial services regulator might have barred or restricted the growth of money market mutual funds in the 1970s because of the competition these funds posed to bank accounts. Such an outcome not only would have been anticompetitive, but also a notable disservice to consumers and to our capital markets.

If the banking agencies are permitted, without limitation, to take a discretionary supervisory action based on their judgment about business risk, they will be able to apply a bank-like regulatory approach and/or impose activity or operational restrictions on mutual fund

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[6] *See* 12 C.F.R. 337.4.

[7] *See* 12 C.F.R. 5.34.

complexes in particular or the securities markets generally. This could profoundly impair the continued successful operation of the existing securities regulatory system and damage our capital markets. Accordingly, we believe it is critical that the standards stipulated for the Federal Reserve Board and the FDIC in H.R. 10 be applied to all banking agencies, including the OCC and the OTS.

V. Nonfinancial Activities

An important objective of any financial services reform legislation is to create competitive equality among banks, mutual funds, broker-dealers, and insurance companies. Unfortunately, H.R. 10 retains a strict separation between "banking" and "commerce." Specifically, a diversified financial services company that becomes a financial holding company would be required to divest its nonfinancial activities within 10-15 years. This approach would introduce competitive inequities: all bank holding companies could enter the securities and insurance businesses, but mutual fund companies, broker-dealers and insurance companies with limited nonfinancial activities would be forced to alter their operations and structure (after some period) in order to enter commercial banking.

Mutual fund companies and other nonbanking financial services firms have never been subject to activities restrictions like those contained in H.R. 10, and should not be penalized if they now become subject to its provisions. Thus, in order to provide a fair and balanced competitive environment, the Institute recommends that H.R. 10 be amended to allow a financial holding company to engage to a limited degree in nonfinancial activities, for example, the amount specified in discussion drafts of Representative LaFalce's "Financial Services Modernization Act" or in the version of H.R. 10 that was passed by this Committee last year.

This would create a financial services holding company that reflects the realities of today's marketplace in which financial companies often engage in limited commercial activities.

VI. Grandfathered Unitary Savings and Loan Holding Companies

Under the Home Owners' Loan Act, in general, any company may control a single savings association and become a so-called unitary savings and loan holding company. Such a company may engage in any kind of commercial or financial activity if its savings association subsidiary complies with the qualified thrift lender test. H.R. 10 would bar a company engaged in any commercial or nonfinancial activities from being a unitary savings and loan holding company, subject to a grandfather provision. Under the grandfather provision, a company that was a unitary savings and loan holding company as of October 7, 1998, or had an application pending before the OTS to become one on or before that date, could retain this status.

As a general matter, the Institute believes that an entity that is engaged in or that has applied to engage in a lawful activity should be eligible for any grandfather provision that is available if the activity becomes prohibited. This approach provides all entities with an equal opportunity to take advantage of an available business opportunity. Moreover, we are unaware of any identifiable risk to the banking system from extending the date. Accordingly, we support changing the applicable date for the grandfather provision to the effective date of H.R. 10.

VII. Conclusion

The Institute continues to support efforts by Congress to modernize the nation's financial laws. H.R. 10 represents a significant milestone in that endeavor, in particular, by permitting affiliations among all types of financial companies, by giving banks full mutual fund powers, by

modernizing the federal securities laws to address bank-mutual fund activities, and by establishing a system of functional regulation.

We support H.R. 10 and are taking this opportunity to suggest and respectfully recommend for your consideration the following: (1) that the same functional regulation standard applied to the FRB and the FDIC be extended to the OTS and the OCC so that regulatory principles of the banking agencies are not inappropriately applied to mutual fund organizations, to the detriment of the investing public and our capital markets; (2) that all financial companies engaged to a limited extent in nonfinancial activities be permitted to affiliate with banks; and (3) that the applicable date for the unitary savings and loan grandfather provision be changed to the effective date of H.R. 10.

We thank you for the opportunity to present our views and look forward to working with the Congress as H.R. 10 moves forward.

Statement of

Michael P. Smith, President

New York Bankers Association

Before the

Committee on Banking and Financial Services

United States House of Representatives

Washington, D.C.

February 10, 1999

Mr. Chairman and Members of the Committee:

I am Michael P. Smith, President of the New York Bankers Association. Our Association represents community, regional, and money center commercial banks throughout the State of New York, which in the aggregate have over $900 billion in assets and more than 210,000 employees.

From a unit bank in Utica to a private bank on Wall Street, from a limited purpose trust company to the nation's largest financial services company, our membership is probably the most diverse group of banks in the world, serving almost every conceivable type of customer. Our Association prides itself on this diversity and on our ability to achieve consensus within this diversity. We are also an organization which, while independent, also prides itself on working closely with our national trade groups and others in the financial services industry to achieve consensus beyond our state's borders.

Such a consensus existed at the end of the last session of Congress and is embodied in the provisions of the bill now before you. Today, that consensus continues among our membership and, we believe, among the financial services industry at large. The time is now to enact financial reform legislation which will provide an appropriate framework for financial competition in the 21st century.

Our Association has supported financial reform for more than a decade. A 1984 State Commission Report, which we supported, identified the need to modify New York State's banking charter. Many reforms required federal action. Therefore, we supported comprehensive federal reform in a 1986 white paper. Our support, then and now, has been grounded in the strong belief that banking's share of the financial market was diminishing and that such erosion is not in the interest of the industry or of our nation. In short, a vibrant banking system is an essential ingredient of a healthy economy.

To achieve reform, we chose a policy of open markets for all financial service firms to play on the now famous but still pristine "level, playing field." The history of the last dozen years - characterized by globalization, new technology and unprecedented innovation - has, as the Committee knows well, only intensified the need for action. A steady pace of de facto reform has emerged from the courts, the regulatory agencies and the states. This

has not disserved banking. In fact, many banks would opt for the status quo if rollbacks were to be the price of federal legislation. But this situation will not help us move to a new global financial system for the 21st century. Only passage of legislation such as H.R. 10 will achieve this goal.

Mr. Chairman, we know that you and your Committee desire reform. You have been tenacious and we would not have this historic opportunity were it not for your leadership. Your hearings will again lay the foundation for reform. In fact, Mr. Chairman, it would be repetitive to retrace old ground. So I will focus today on the process that brought key changes in H.R. 10 in the insurance area. I will then describe for you the substance of these amendments.

It is no secret that only a handful of banking firms were supporting the final product which emerged from the House of Representatives last Spring. It is also no secret that banks were fairly isolated in this opposition within the financial services sector. The insurance provisions were by far the most vexing to banks of all sizes. These provisions were not reform. They were retrenchment. That certainly was the belief in New York and we made this view known on the Hill.

As a consequence, reports were circulating in Washington that the banking and insurance war was alive again. That was the opposite of our experience back home in New York where in 1997 we joined an historic detente with our insurance agent groups and strengthened our close ties with the securities and insurance company organizations - bedrock industries for the future growth of New York and the Northeast. These developments were not lost on then Chairman D'Amato of the Senate Banking Committee when he spoke at our annual meeting last March, along with Travelers' Sandy Weill, AIG's Maurice Greenberg, Chase's Tom Labrecque, and George Hamlin of Canandaigua National Bank in upstate New York. They all agreed that financial reform is essential but not at the expense of any one industry or segment.

From our perspective, the bank-insurance issues have always been a war on two-fronts: state and federal. At the federal level, the unanimous Supreme Court decisions in *VALIC* and *Barnett* in 1995 and 1996 established the fact that, under federal law, national banks can sell annuities and have town-of-

5000 insurance agencies that can sell all types of insurance under rules specified by the OCC. The *VALIC* decision on annuities closely mirrored a unanimous New York case validating the sale of annuities by New York banks. The aftermath of *Barnett* of course was a firestorm of activity in many states including New York. The reality for banks is that *Barnett* remains an important benchmark against which financial reform is measured.

At the state level in New York, we chose to respond to *Barnett* by reaching detente with the insurance industry. The guiding principle was functional regulation, where New York banks agreed that insurance activities should be subject to the State Insurance Department and to certain additional safeguards. In a bipartisan manner, we protected state banks through passage of a wild card statute whose purpose is to ensure that state banks may exercise the same rights and powers and engage in the same activities as their national counterparts - thus providing parity with national banks.

In the last Congress, H.R. 10, as adopted by this Committee, was subsequently revised in later House action, which on the whole was a significant step backward for the banking industry, and in fact had the potential to unravel what had been accomplished in New York. Rather than just oppose the bill, however, our Association's Board authorized us to seek improvements in six critical areas. The most complex and contentious area was insurance.

When H.R. 10 reached the Senate last Summer, the leadership of the Senate Banking Committee, on a bipartisan basis, specifically turned to us to initially host negotiations aimed at breaking the logjam on the insurance language among agents, companies, commissioners and the banks.

These negotiations went on intensively from July to early October. As you know, the differences among the bank and insurance groups go back many years. Who can forget those difficult votes on FDICIA? These differences draw on principled views that have been deeply held, and the economic stakes in the outcome are enormous.

While the task was arduous and sometimes tedious, everyone around the table was professional, amicable, and mutually respectful - and in the end, very productive. Through the classic process of give and take, we fashioned

a document that was probably longer and more complex than any of us would have preferred, but that achieved a fine balance that each interest could accept.

Many groups not immediately at the table were kept in close touch. I also was serving as Chairman of the State Association Division of the American Bankers Association, which provided a very valuable linkage with banking's grassroots. Ultimately, all elements of the insurance and banking industries came to embrace the agreement - for the first time in the very long history of the financial reform effort. As a result, also, 49 state bankers associations moved from opposition to the bill last Spring to 49 in support last Fall.

Before turning to the particulars of this agreement, several important points should be noted. Our mandate was to work within the framework of the House-passed bill. We were not starting from whole cloth. For example, even though banks in a number of states for years have been butting their heads against subtle but effective state laws that kept them out of the insurance business, we were not at liberty to seek a blanket preemption of all laws that have a discriminatory effect - a result that we would readily endorse. Rather, our task was to find a flexible and workable framework for *both* banks and insurance interests, without affecting the consumer protections worked out in the House.

Our negotiation had to address three distinct problems: first, state actions that effectively prevent insurance-bank affiliations; second, state laws regarding activities other than sales, such as insurance underwriting; finally, and most contentious, provisions concerning insurance sales - the vexing dispute between the agents and the banks. In the end, we did reach an agreement that allowed each of the participating trade associations to sign off on the result.

In summary the agreement included the following particular elements:

First, effective preemption of anti-affiliation laws. The new language in section 104 of the bill contains a healthy new standard prohibiting a state from preventing or restricting any affiliation authorized by the bill. It therefore ensures that banks and insurance companies will be free to affiliate throughout the country, even in those states that prohibit such affiliations.

This section includes language sought by state insurance commissioners to expand their authority to ask for pertinent documents from potential acquirers and require maintenance of acceptable capital standards, among other provisions. This balance, while ultimately not acceptable to the insurance commissioners, was embraced by all other parties and the Senate Banking Committee.

Second, effective anti-discrimination language in connection with non-sales activities in subsidiaries and affiliates. The anti-discrimination section goes to the heart of a workable bill. Insurance companies that are affiliated with banks must be treated the same as those that are not. Section 104(b) sets forth the standard to govern state regulation of newly authorized activities of depository institutions and their subsidiaries and affiliates. In general, states are precluded from preventing or restricting banks and their affiliates from engaging in any activity authorized under the bill unless the regulation is one of general applicability and does not discriminate against depository institutions on its face or as applied. A separate standard governs bank insurance activities, particularly sales and cross-marketing activities, but the general standard gives banks a measure of protection from adverse regulation that ensures evenhanded regulatory and supervisory treatment for the activities newly authorized under the bill.

Third, a carefully balanced set of insurance sales provisions, including a number of elements:

- **Preserving *Barnett*.** The holding of the Supreme Court in the *Barnett* case is expressly preserved and a general standard is adopted that a state may not prevent or significantly interfere with the ability of a bank, its subsidiaries or affiliates to engage in insurance sales, solicitation, and cross-marketing.

- **For new law, adopting strong anti-discrimination language.** For laws adopted after September 2, 1998, the same anti-discrimination standards applicable to non-sales activities apply. In court cases under this provision, determinations of the OCC and state insurance regulators will be considered without unequal deference.

- **For old law, preserving deference in court cases**. The OCC will receive deference under the *Chevron* standards in any cases addressing laws adopted prior to September 2, 1998.

- **Providing a modified safe harbor for state insurance sales regulation**. There was widespread belief that the safe harbor, designed as a specific carve out for state regulation, was too extensive and could act as an incentive for further state laws adverse to banking. New York was one of the states that had specifically negotiated a set of acceptable standards and felt that the provisions of the House bill were too extreme. The safe harbor now in H.R. 10 avoids such extremes, while responding to the concerns of insurance regulators, agents and certain consumer groups regarding new competition from banks.

It is expected also to provide the opportunity for states to secure various consumer protections in the disclosure and anti-tying areas. It is also designed to protect especially smaller banks from seemingly neutral provisions such as sharing of facilities that in essence block them from using their new authority to sell insurance.

The safe harbor now represents a consensus view of all the interested groups. Could banking have lived without a safe harbor? Absolutely. Could it have been dropped? Absolutely not.

Fourth, deletion of the requirement that banks must acquire existing agencies. This provision was one of the early casualties of the discussions. It was recognized as a non-starter from the beginning and its deletion was essential for bank support. Additionally, modifications to the anti-competitive title insurance provisions were very important to banks and were made part of the final product.

As you consider these provisions, we as an Association are available to explain the language in H.R.10 and pledge to work with you with respect to any other ideas or proposals that may come before you. At the same time, I must reiterate that the insurance package in H.R.10 is finely balanced. We earnestly hope that any suggested changes be carefully considered in full consultation with all the parties.

Like the insurance amendments, there were other significant changes to H.R. 10 which we strongly urge be retained. They include the closing of the unitary thrift loophole - a loophole that is encouraging the creation of numerous Federally-insured depositories owned by commercial, industrial and retail firms. We also strongly support the compromise securities language now contained in the bill which reflects, we understand, extensive negotiations between the national banking and securities trade associations.

It is recognized that H.R.10 is not perfect. There will not be perfection in such a complex document. But it is balanced. It is the amalgam of thousands of hours of work by thousands of hands. We were just one of those hands. As such, we respectfully urge that you proceed in finishing the work which you have so ably fostered.

We thank you for the opportunity to testify today.

NYBA

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Michael P. Smith
President

March 9, 1999

Committee on Banking and Financial Services
2129 Rayburn House Office Building
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Also, during my testimony on H.R. 10, two members of the Committee asked for our response for the record on certain provisions of the bill. Representative Rick Hill of Montana asked whether title insurance sales by national banks could continue to be regulated by state insurance commissioners; and Representative Stephanie Tubbs Jones of Ohio asked for the Association's position on the Community Reinvestment Act and consumer protection provisions of the bill. We respectfully submit these responses to the Representatives' questions.

1. State Regulation of Title Insurance: Title insurance sales activities have always been regulated by state law. H.R. 10 would explicitly preserve that regulation through several provisions. First, section 301 of the bill reaffirms the continuing vitality of the McCarran-Ferguson Act. As you know, that Act commits the regulation of insurance to the states where no contrary federal statute has supervened. Section 302 explicitly requires that insurance agents, including those employed by or associated with a bank or its affiliates, be licensed under state law by a state insurance department, subject to the nondiscrimination and other requirements of section 104. Section 303 mandates the functional regulation by state insurance departments of insurance sales activities by national banks. So long as a state defines title insurance as insurance and regulates its sales as the sale of insurance, H.R. 10 would ensure that title insurance sales activities by national banks are regulated precisely as are those by any other title insurance agent to the extent that a state does not attempt to prevent a national bank-affiliated agent from selling the product at all or attempt to discriminate in the regulation of title insurance sales against agents affiliated with national banks.

In New York, where state regulation authorizes state-chartered banks to sell title insurance, the State Legislature in 1997 mandated licensing of state bank sales activities and the regulation of those activities by the state insurance department. Attached is a copy of the 1997 statute for the record. New York's Banking and Insurance Departments have been engaged in a cooperative effort since that time to ensure that bank insurance sales activities are appropriately regulated for the protection of the consumer and in the interest of fair and equal competition.

2. CRA and Consumer Protection: New York recognized early in this decade that the Community Reinvestment Act as then interpreted and enforced had become far more productive of paperwork than of results. Under the leadership of then-Banking Superintendent Derrick Cephas, we embarked on a project to reform CRA - a project that was later adopted in large part by the Federal banking agencies. Our Association strongly supported the revised regulations recently adopted by the federal banking agencies and by the New York Banking Department. While the implementation of these regulations is still too recent to judge their effectiveness, we have heard no complaints from any of our members as yet about them.

As to the consumer protection provisions in the insurance section of H.R. 10, our Association was directly involved in negotiating the "safe harbor" for state insurance protection laws contained in section 104. These provisions ensure that a state can maintain a number of bank-specific consumer protection laws when they are deemed in the best interests of the citizens of the state even when they may apply only to bank-affiliated agents and not agents generally. The "safe harbor" provisions were the product of lengthy negotiations among banking, insurance agent, insurance company and state regulatory groups. We continue to support their inclusion in H.R. 10.

We appreciate the opportunity to respond on these important issues. We would be pleased to provide any additional information you may need.

Sincerely,

Michael P. Smith

Independent Insurance Agents of America

N·A·L·U

The National Association of Life Underwriters

Testimony of

WILLIAM B. GREENWOOD

President

Independent Insurance Agents of America, Inc.

Before the

Committee on Banking and Financial Services

U.S. House of Representatives

February 10, 1999

Mr. Chairman, and members of the Committee, my name is William B. Greenwood. I am president of the Lawton Insurance Agency located in Central City, Kentucky, President of the First United Bank Holding Company, a member of the board of directors of the Central City First National Bank, and I am currently serving as President of the Independent Insurance Agents of America, Inc. Mr. Chairman, I hope that from my unique vantage point as an active member of both the insurance and banking industries that I will be able to assist this Committee in its consideration of financial services reform.

I appear today on behalf of the insurance agents of America, and their employees -- more than 500,000 men and women who work in every part of the United States. These people are represented by both the Independent Insurance Agents of America, Inc. (IIAA) and the National Association of Life Underwriters (NALU) on whose behalf I testify today. Their members sell and service all lines of insurance.

INTRODUCTION

First, Mr. Chairman, let me thank you for holding this hearing today. Throughout your career, you have been a friend to small business people. In the world of great international commerce and giant corporations, the problems and concerns of small businessmen and women may not seem important. But you have not forgotten that the small businessman and woman are what have made this Country great -- their zeal and innovation have enabled our economy to grow to what it is today. Insurance agents are such small business people. We work hard every day, a lot of us own our businesses; we survive by providing expertise and service to our customers. And all we ask is to have a fair chance to succeed.

IIAA and NALU are appearing before you today to comment on the newest version of H.R. 10, the "Financial Services Act of 1999," that you reintroduced on the very first day of this new Congressional term, Mr. Chairman. Before proceeding with my comments, I must commend you for the tenacity that you have shown in your repeated forays into the financial services reform quagmire. IIAA and NALU support your efforts, Mr. Chairman, to clarify the applicable legislative requirements and we applaud your initiatives to clarify the appropriate insurance sales regulatory parameters to which all participants in the business of insurance must be subject in the financial services modernization era. In the days and weeks to come, we would like to do our best to assist you in ensuring that this is your last foray into the quagmire and that those days and weeks do not become more months and years of irresolution of these important issues.

As you know, Mr. Chairman, we have in the past advocated that the traditional separation between the banking and insurance industries should be maintained. During your consideration of H.R. 10 last term, however, we for the

first time came to you prepared to support financial modernization in the form of affiliations between banking, securities, and insurance entities. My joint roles as both an insurance agent and a bank holding company president are unique only in magnitude; the market is evolving even in the absence of new legislation and today more than ever before agents are entering into an increasing number of relationships with members of the banking and securities communities. We can accept formal affiliation relationships, however, only if there is clear functional regulation of the insurance activities of every entity, and only if insurance consumer protections are addressed. My comments will focus on the extent to which we believe that the current version of H.R. 10 accomplishes this objective and the extent to which we continue to believe improvement is necessary.

As an initial matter, however, it should be understood that the monumental shift in our position has not come easily. As small business people, we are painfully aware that, as a practical matter, such affiliations will be a one-way-street. That is, the average insurance agency is not going to be in the position to acquire a bank; the acquisition will run the other way. But we are convinced that we can not only survive, but thrive, in such a new world. True competition can work and consumers will benefit, however, only if the rules of the game establish a level playing field for all participants. It is that which we seek and it is that -- from my unique perspective with strong interests in both the insurance and banking arenas -- which I personally endorse.

The historic change in our position on affiliations has been prompted by marketplace and political reality. The Supreme Court's decision in *Barnett Bank of Marion County, N.A. v. Nelson*[1/] holding that the Section 92 power[2/] granted to town-of-5000 national banks to act as insurance agents preempts State laws that would otherwise prohibit such conduct, coupled with the Comptroller of the Currency's ever-broadening interpretations of Section 92, effectively vitiate the separation between the industries. And Congressional inaction to reign in the OCC's creation of new policy by administrative fiat has exacerbated the situation.

At the same time, the *Barnett* decision has created a great deal of uncertainty regarding who has regulatory authority over bank sales of insurance and what is the extent of any such authority. This uncertainty is undermining the efforts of all of the participants in the insurance sales arena -- insurance companies, insurance agents, banks and State regulators -- to move the insurance industry into the twenty-first century. The contents of this statement will therefore focus not on whether financial institutions should be permitted to

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1/ 116 S. Ct. 1103 (1996).

2/ 12 U.S.C. § 92.

affiliate with insurance providers -- we do not oppose such relationships -- but on the need for the functional regulation of all members of the financial and insurance industries. Especially in the insurance context, we believe that it is essential that all insurance activities continue to be regulated at the State level -- where they have been regulated for nearly two centuries -- subject only to the restriction that no State may *actually or constructively preclude* any entity or its affiliate that has been authorized under Federal law to engage in the business of insurance from exercising such powers. In championing this approach, we recognize the pressing need for eliminating the barriers that still exist between the banking, insurance and securities industries so that members with roots in all three sectors will better be able to serve the needs of their customers. We believe, however, that this concern also mandates ensuring that consumer choices are well-informed and freely made and, in the insurance context, state regulators have been the virtually exclusive protectors of such interests since the creation of an insurance industry in this country. This bill must ensure that their authority and expertise in the regulation of the business of insurance is not overturned or undermined in any way as other industries become more heavily involved in providing insurance services.

This Statement is divided into five parts: Part I explains why the regulation of insurance activities *of everyone* should be left to the States; Part II discusses the current need for the clarification of insurance regulatory powers; Part III analyzes the positive aspects of the functional regulation provisions included in H.R. 10; Part IV explains why we believe that the H.R. 10 approach is still problematic in certain respects; and Part V discusses the consumer protection provisions being considered and adopted at the state level, counters the charge that these provisions are "anti-competitive," and explains the degree to which these state regulatory requirements would be threatened by the proposed legislation in its current form.

I. Regulation of the Business of Insurance Should be Left to the States

Because no insurance licensing and regulatory scheme exists at the federal level, the only available regulators of the participants in the insurance industry are the States themselves. Some national banks, however, appear to believe that they are exempt from at least some of the governing insurance regulations in States in which they are currently engaging in the business of insurance. Although the OCC has recognized that State laws generally apply to national bank sales of insurance, it also has emphasized that national banks need not comply with State laws that interfere with their activities. Without the creation of a federal regulatory authority or a reaffirmation of the absolute right of States to regulate such insurance activity, the scope of this "exemption" will remain unsettled and national banks may be free to engage in the business of insurance without significant oversight.

Given the sophisticated insurance licensing and regulatory structure developed exclusively at the State level over the past 200 years and given the current climate disfavoring the creation of more federal regulatory authority (especially when it is duplicative of current State efforts), reaffirmation of the right of States to regulate the insurance business appears to be the only viable solution. Such reaffirmation is required to ensure that all entities involved in the insurance industry are on a level playing field; to ensure that they are all subject to effective consumer protection requirements; and to ensure that the insurance-buying public has consistent assurances of quality.

Any such reaffirmation would not be new or radical. To the contrary, it merely would build upon and clarify a federal policy that has been in place for over 200 years that States have virtually exclusive regulatory control over the insurance industry. Indeed, up until 1944, it was universally understood by everyone (including Congress) that Congress has no constitutional authority to regulate the business of insurance. This changed with a single Supreme Court decision issued that year. Congress responded immediately by enacting the McCarran-Ferguson Act, which "restore[d] the supremacy of the States in the realm of insurance regulation."[3/]

McCarran's statement of federal policy could not be more clear: "The business of insurance, and every person engaged therein, shall be subject to the laws of the several States which relate to the regulation or taxation of such business."[4/] Given the States' historical expertise in the realm of insurance regulation and the absence of any such expertise at the federal level, there does not appear to be any compelling reason for abandoning this traditional policy approach.

At a time when Congress is seriously considering empowering States in a myriad of areas, Congress should not strip the States of their authority to regulate in a business arena that has been within their virtually exclusive domain throughout this country's fruitful history.

The States are the only logical choice for comprehensive regulation of insurance. Although there are uniform national concerns in this industry as in many others, in uncountable ways, insurance involves concerns of an intensely local nature. The concerns in Iowa, for example, with hundreds (if not thousands) of farmers and few large urban areas, are very different than the insurance issues

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3/ United States Dep't of Treasury v. Fabe, 113 S. Ct. 2202, 2207 (1993).

4/ 15 U.S.C. § 1012(a).

raised in New Jersey, with its coastal resort communities, urban centers, and manufacturing concerns.

The public has a substantial interest in the continued functional regulation of insurance by the States, regardless of who is conducting the activities. Because of the social need for insurance and its importance to the public, the underwriting and sale of insurance has become one of the most highly regulated professions today. By their regulation, the States ensure that those who engage in the business of insurance are qualified to do so, remain appropriately qualified, offer sound insurance products, and comply with reasonable safeguards for the protection of consumers. This entire body of State insurance statutes and regulations is frequently revised and updated to address evolving regulatory issues and to ensure comprehensive consumer protection. Preservation of the applicability of these State regulations is essential because, at least at the current time, no comparable regulations exist at the federal level and no federal regulator has expertise in this arena.

II. The On-Going Need for Clarification

In March 1996, the Supreme Court issued its decision in *Barnett*. The Supreme Court's central holding was that Section 92 preempts State laws that prohibit national banks from selling insurance, pursuant to their Section 92 authority. In the course of rendering this decision, however, the Supreme Court also acknowledged that "[t]o say this" -- to say that Section 92 preempts State laws that would otherwise prohibit small-town national banks from selling insurance -- "is not to deprive States of their power to regulate national banks, where (unlike here) doing so does not prevent or significantly interfere with the national bank's exercise of its powers."[5/] Permitting affiliations would, of course, make clear that States may not *prevent affiliations* but such an authorization would not necessarily shed any light on what regulatory efforts might be deemed to "significantly interfere" with the activities of these affiliated entities. We believe that State laws and regulations that do not *actually or constructively -- that is, directly or indirectly -- prohibit* such affiliations cannot be deemed to "restrict" or "significantly interfere" with them.

A request for comments issued by the OCC on January 14, 1997 dramatically illustrates the conundrum.[6/] The question at the heart of the OCC's consideration is whether any provisions of the State of Rhode Island's "Financial

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[5/] Barnett, 116 S. Ct. at 1109.

[6/] See 62 Fed. Reg. 1950 (Jan. 14, 1997).

Institution Insurance Sales Act" ("Rhode Island Act")[7] which governs the insurance activities of financial institutions should be deemed preempted by Section 92. An anonymous Requestor that asked the OCC to consider this issue contends that five of the provisions included in the Rhode Island Act "discriminate" against national banks and significantly interfere with the exercise of their Section 92 powers.[8]

The Rhode Island Act was supported by a bipartisan group of state legislators. Indeed, it was agreed to by a significant portion of the State's banking industry. From my perspective as both an insurance agent and a banker and based on my familiarity with the nature of these negotiations both in Rhode Island and in the other twenty-three States that have enacted similar laws and regulations, I do not believe that a desire to penalize banks played a part in the legislative process in either Rhode Island or elsewhere. As reflected in the Rhode Island Governor's statement upon signing, the Act is designed to level the playing field. None of the provisions at issue actually or constructively preclude national banks from engaging in the business of insurance in any way, and none of the challenged provisions impose different requirements on national banks than those imposed on any other financial institution engaging in the sale of, or in the solicitation for the purchase of, insurance products.[9]

The OCC, however, apparently believes that these provisions may "significantly interfere" with a national bank's exercise of its Section 92 powers, although the agency has not articulated the standard by which any such significant interference will be measured.[10] Indeed, based on the OCC's

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[7] See R.I. Gen. Laws §§ 27-58-1 et seq.

[8] 62 Fed. Reg. at 1951.

[9] The challenged provisions generally prohibit the tying of banking and insurance; generally require that a financial institution's loan and insurance businesses be physically segregated; generally prohibit financial institution employees with loan or deposit-taking responsibilities from soliciting and selling insurance; require that loan and insurance transactions be completed independently and through separate documents; and prohibit usage of nonpublic customer information without the written consent of the customer. See id.

[10] Remarkably, the OCC first sought comments on the preemption of the Rhode Island Act before the State Insurance Department had finalized regulations that would implement the statute. We, among others, pointed out the prematurity of the OCC's request. Apparently recognizing its error, the OCC recently reopened (continued...)

supplemental request for comments on the issue, it appears that the OCC is prepared to impose its own views of how best to legislate on the States. Not only is the OCC inquiring whether the Rhode Island provisions prevent or significantly interfere with national banks' insurance sales activities, the OCC is asking whether there are "better" means that the State might have chosen to effectuate its policy goals. This is clearly beyond the OCC's legitimate role as banking regulator. It is the role of legislators -- and in this context, State legislators -- to determine how best to effectuate public policy, not the OCC.

During the first round of comments, numerous members of Congress expressed their belief that it was inappropriate for the OCC to attempt to preempt any State insurance laws. No member voiced the opposite view. Nevertheless, the OCC labors on, possibly prepared to opine that these state law provisions -- enacted on a bipartisan basis by state legislators ***with the agreement of significant representatives of the banking industry in the State*** -- should not be applied to national banks. Interestingly, the Rhode Island law has been in force now for over two and a half years and all players seem to be functioning remarkably well.

The question whether any of the provisions of the Rhode Island Act may be preempted is not an isolated one. Sixteen other States have enacted laws that seek to regulate bank involvement in insurance sales activities,[11/] another

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[10/] (...continued)
the comment period to permit consideration of the finalized regulations. It is only in light of those regulations that the meaning of the statute can be ascertained.

[11/] Arkansas (House Bill 2070 (1997)); Colorado (House Bill 97-1175 (Colorado Rev. Stat. §§ 10-2-601 et seq.)); Connecticut (Public Act No. 97-317 (Connecticut Gen. Stat. § 36a-775)); Illinois (House Bill 586 (1997) (The Illinois Insurance Code Article XLIV)); Indiana (House Enrolled Act No. 1241 (1997) (Indiana Code §§ 27-1-15.5-8 et seq.)); Kentucky (Kentucky Laws Ch. 312 (H.B. 429) (1998) (Ky. Rev. Stat. § 304)); Louisiana (House Bill No. 2509 (1997) (La. Rev. Stat. 22:3051 - 3065)); Maine (S.P. 439 - L.D. 1385 ((9-A Maine Rev. Stat. Ann. §§ 4-401 et seq.)); Massachusetts (Senate 1948, Bill No. MA97RSB (May 15, 1998)); Michigan (House Bill No. 5281 (1993) (Mich. Compiled Laws § 500.1243)); New Hampshire (House Bill 799 (1997) (N.H. Rev. Stat. Ann. §§ 406-C et seq.)); New Mexico (House Bill 238 (43rd Legislature, 1st Sess.) (New Mexico Stat. Ann. §§ 59A-12-10 et seq.)); New York (Bill No. 5717-B (July 18, 1997) (New York Banking Law § 14-g; New York Insurance Law §§ 2123 and 2502) (sunsets July 18, 2000)); Pennsylvania (House Bill 1055 amending the Act of May 17, 1921 (P.L. 789, No. 285), Printer's No. 1985 (June 9, 1997), 40 Penn. Stat.); Texas (House Bill No. 3391 (1997) (Texas Insurance Code Article
(continued...)

seven have acted by regulation,[12] and at least six other States are now considering legislation to regulate bank sales of insurance. And, in the meantime, the OCC is meeting with State insurance regulators intimating that it is prepared to preempt any laws or regulations that it views as going to far. There is thus an intense need to clarify the scope of the States' regulatory authority in this area.

Such clarification would benefit everyone involved. State legislators and regulators would clearly understand the bounds of their authority, and disruption of the legitimate state legislative process would be avoided. Both the insurance and the banking industries would be relieved of the uncertainty that currently permeates and, to large part, stifles the business. And the OCC would be freed of the burden of making piecemeal determinations of whether individual state laws are or are not preempted.

III. The Positive Aspects of H.R. 10 -- Supporting Functional Regulation

The version of H.R. 10 that you introduced this term, Mr. Chairman, includes insurance sales provisions that were negotiated by members of both the banking and insurance communities. The resulting proposal therefore includes several provisions that we believe go a long way toward resolving many of the open issues related to the regulation of bank sales of insurance products. Section 303 of the proposal, for example, includes a positive statement that the insurance sales activities of everyone (including banks) is to be functionally regulated by the States. This provision should discourage the Comptroller from initiating any attempt to comprehensively regulate national bank insurance sales practices directly and it should therefore serve as a defensive measure against the creation of a two-tiered track of regulation. In this same vein, Section 301 would reaffirm the continued validity of the McCarran-Ferguson Act and its requirement that States are charged with the responsibility for regulating the business of insurance and Section 302 includes a positive statement that everyone engaged in the sale of insurance products must be properly licensed in accordance with state law.

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[11] (...continued)
21)); and West Virginia (H.B. 2198 (March 14, 1997) (W.V. Code Chapter 33)).

[12] Florida (Dept. of Insurance Rules 4-224.001 - 4-224.014); Georgia (Rules and Regulations of the Office of the Commissioner of Insurance Chapter 120-2-76 (adopted February 17, 1997)); Maryland (Advisory Letter Issued by the Insurance Commissioner and the Commissioner of Financial Regulation on October 31, 1996); Mississippi (Executive Memorandum issued by the Commissioner of Banking and Consumer Finance on May 13, 1997); Ohio (Department of Insurance Rule 3901-5-08); Vermont (Insurance Division Bulletin 117 (June 13, 1997)); and Wyoming (Chapter 16 of the Rules of the Division of Banking).

Although at first blush this latter provision may appear to merely state the obvious, the OCC and several national banks are on record as stating that national banks need not be licensed to act as insurance agents in any State, although they can voluntarily decide to do so.

In terms of specific consumer protections, Section 104(b)(2)(B) includes a list of thirteen different categories of regulations that would be protected from preemption. States need not enact precisely the same laws, but so long as they are substantially the same and no more burdensome or restrictive than the provisions set out in the safe harbors, the state laws cannot be preempted. These safe harbor provisions would apply to both current and future laws. In addition, Section 307 would establish federal minimum levels of consumer protections that would be applicable in States that have not enacted bank-specific insurance sales consumer protections laws. The bill would require the federal banking regulators to implement the requisite consumer protections and they would be applicable wherever the state laws are not as protective of consumers' interests.

Finally, for preemption challenges to state insurance laws enacted in the future, Section 306 enables state insurance commissioners to challenge a federal banking regulator's view that a state law should be preempted and avoid the court giving exclusive deference to the federal banking regulator's view. Currently, the OCC (and other federal banking regulators) argue that their view on the preemption issue is entitled to deference by the courts and that insurance commissioners are not entitled to such deference because they are not *federal* regulators. Although we strongly contest any such deference entitlement in the preemption context, this provision would resolve that outstanding controversy and make clear that the opinions of state regulators are entitled to a heightened degree of consideration when the viability of their insurance regulations is at issue.

IV. The Negative Aspects of H.R. 10 -- Undermining Functional Regulation

H.R. 10 goes a long way toward preserving the functional regulation of insurance. But it does not, in our view, go far enough because enactment of the current H.R. 10 draft would jeopardize many of the consumer protections already in place in many states that are designed to ensure that consumers are well-informed and free to choose to purchase insurance products adequate to address their insurance needs. It is for this reason that we believe four changes would improve the proposed legislation: (1) clarify the proper preemption standard; (2) eliminate the so-called "non-discrimination" provision; (3) clarify that state insurance regulators are entitled to receive consideration of their views in court when disputes arise between regulators; and (4) strengthen and clarify the safe harbor consumer protection provisions.

Clarify the Appropriate Preemption Standard. In any financial services reform legislation finally adopted, this Committee must reiterate that ***every entity*** that engages in the underwriting or sale of insurance is bound by state law regulating that activity and such State laws may be preempted ***only if they actually or constructively prohibit*** national banks or bank-affiliated entities from exercising their federally authorized insurance powers. This is the clarification of the *Barnett* standard we seek. More specifically, we believe the preemption standard applicable to insurance sales activities set forth in Section 104(b)(2) must be revised. Although Section 303 rightly makes clear that insurance sales activities shall be functionally regulated by the States, that requirement is subject to the Section 104 preemption standards. Hence, any such state regulation is limited such that any regulatory requirement relating to insurance sales that "prevents or significantly interferes" with national banks' insurance sales powers -- including their sales authority under Section 24(Seventh) -- is prohibited. Particularly since, under the current draft, the OCC will be interpreting this provision of the National Bank Act, as the relevant administrative agency, this standard is too uncertain and open to litigation. We suggest it be replaced with a clear statement that the only limitation on the States' manner regulation be that they cannot actually or constructively prevent national banks' insurance sales activities. This is, in our view, the import of the line of Supreme Court cases that led to the *Barnett* decision. This is the level of "interference" the Supreme Court had in mind when limiting the States' authority, since preemption generally requires an actual conflict between state and federal law.

We note that H.R. 10's standard is actually an extension of the *Barnett* decision, not a mere codification, as it purports to be. *Barnett* applied only to state laws applicable to national banks' insurance sales activities under Section 92 (12 U.S.C. § 92, Section 13 of the Federal Reserve Act), whereas H.R. 10's provision imposes a *Barnett* standard on state regulation of all national bank insurance agency activities, including those under Section 24(Seventh) -- the so-called "incidental banking powers clause." This includes credit insurance and annuities sales activities. In two separate cases, the courts have held that, unlike with Section 92, the McCarran-Ferguson Act protects state regulation as it relates to possible preemption by Section 24(Seventh). Thus, McCarran would permit a State to prevent a national bank's sale of insurance under Section 24(Seventh) -- let alone "significantly interfere" with such sales; *Barnett* does not apply in this context. H.R. 10 effectively overrules these decisions as they apply to insurance sales activities of national banks under Section 24(Seventh).

Eliminate the "Non-Discrimination" Provision. Section 104(c) prohibits States from distinguishing in any way between financial institutions and other entities -- and from enacting provisions that have a greater effect on financial institutions than on other entities -- in regulating the sale of insurance products. As over 25 States and the OCC itself have previously recognized,

however, the sale of insurance products by financial institutions creates unique problems that require consumer protections tailored for the financial institution context. These laws are not "anti-competitive." Indeed, they expressly recognize that banks are in the business to stay. But they attempt to create a level playing field between bank and non-bank insurance agents and brokers, and to protect consumers from potential abuse. Banks' access to cheap funds, FDIC-insured status, and control over credit, puts them in a position not held by others in the insurance industry. For this reason, many States believe provisions regulating bank sales of insurance are necessary to prevent coercion and confusion and to protect customer privacy.

Indeed, as the OCC itself recognized when it published an advisory letter to provide guidance to national banks on insurance and annuity sales activities,[13/] there are many instances in which "discriminatory" regulation (in the sense of treating banks differently than non-banks) is appropriate and necessary. Consequently, there is no basis on which to argue that the type of "discrimination" present in consumer protection provisions such as those contained in the Rhode Island Act are per se illegitimate.[14/]

In working on these laws at the state level, agents have negotiated with all interested parties -- banks, insurance companies, securities firms. Michigan's law, enacted almost six full years ago, is the product of negotiations between the banks and the agents. West Virginia's law, enacted two years ago, is the product of negotiations that included not just the banks and the agents, but insurance companies as well. The process has been no different in the other twenty-two States.

Although the safe harbor provisions are an effort to capture many of the substantive regulatory controls that currently are imposed, they are both underinclusive of the current universe of regulatory requirements designed to address bank-specific consumer protection issues and they cannot possibly take into consideration the wide array of issues that may in the future require bank-specific regulatory solutions. As long as the legislation makes clear that States may not prohibit the exercise of authorized insurance sales powers, there should be no need to bar state legislatures and governors from implementing bank-specific solutions designed to address consumer protection concerns that may arise when such powers are exercised.

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[13] See OCC Advisor Letter AL 96-8 (October 8, 1996).

[14/] Absolutely nothing in the Barnett decision, or its precedents, supports the argument that a State cannot regulate national banks in a manner that distinguishes them from non-banks.

Clarify That The Opinions of State Insurance Regulators Are Entitled To Consideration In Court Reviews of State Insurance Laws. The viability of regulatory provisions already in force in many States would be put into jeopardy because of the implication created in the bill that the OCC is entitled to exclusive consideration when a court confronts the question whether a challenged provision should be preempted because it "interferes" with a national bank's exercise of its insurance sales powers. Although Section 306 creates a special procedure for the challenge of state insurance regulations and dictates that the state insurance regulator and the OCC are entitled to equal consideration during that review, Section 104(b)(2)(C) exempts laws in existence prior to September, 1998 from the "no unequal deference" standard. The OCC, however, simply has no expertise in the regulation of the business of insurance. Moreover, the OCC has repeatedly demonstrated that the expansion of national bank powers is at the forefront of its concerns. This preoccupation has led the OCC to interpret a small exception to the general prohibition on national bank sales of insurance that authorizes national banks located and doing business in places with populations not exceeding 5,000 inhabitants as allowing national bank agents to sell from anywhere so long as they are headquartered in a small-town bank office and to sell to customers located anywhere without any geographic restriction whatsoever. For these reasons, we believe that OCC interference with State regulation of the business of insurance -- and exclusive consideration of OCC opinions regarding such regulation -- is inappropriate. The Courts are well qualified to determine whether State regulations prevent or significantly interfere with a national bank's exercise of its insurance sales authority and requiring or implying that the OCC is entitled to special deference over and above that accorded state insurance regulators on such questions is therefore unacceptable.

Strengthening The Safe Harbor Provisions. Finally, we believe that the current list of safe harbors must be strengthened. Consumer protection provisions that are at the heart of the regulation of banks sales of insurance in many states -- requiring separation of banking and insurance personnel and activities, for example -- have been excluded from the list of consumer protections that are automatically deemed to be permissible. That exclusion jeopardizes the application of many such provisions and may undermine the regulatory scheme of many States that have been designed to address many of the unique issues that arise when banks -- in their unique position controlling federally insured credit capital -- also engage in the business of insurance.

CONCLUSION

The financial services mechanism H.R. 10 seeks to establish must function in the real world. That can only be accomplished if there is true functional regulation. We believe that virtually everyone in Congress supports such functional regulation. The task is to implement it effectively. The affiliations

contemplated by H.R. 10 are exciting and probably necessary. But there must be a level playing field for everyone in the industries involved. Small business concerns cannot be swept away by the resulting mergers of the bigger players. And, most importantly, the interests of consumers that state insurance regulators have been exclusively charged with protecting for decades must remain at the forefront.

It is clear that the absence of sufficient regulatory authority over national banks -- or any other entity -- that is active in the insurance arena is a problem. Neither the Comptroller nor any other federal regulator possesses the necessary expertise to regulate the vast intricacies of the insurance business or of financial institutions' participation in that business. For this reason, and for the reasons delineated at length above, IIAA and NALU urge this Committee to recommend enactment of legislation that clarifies that all entities that engage in the business of insurance -- including national banks and any other entity in a new financial services holding company -- are bound by state law regulating those activities; such State laws are preempted only if they actually or constructively prohibit the exercising of federally authorized insurance powers; and the opinions of state insurance regulators are entitled to consideration during any court review of such questions. This would maintain the status quo by ensuring that the States remain the paramount regulatory authority for the insurance industry. Without enactment of such legislation, the emerging regulatory void in portions of this industry will continue to fester. The primary victims if such a bill is not enacted will inevitably be the consumers who are confronted by the unregulated participants in the essential but highly complicated business of insurance.

STATEMENT OF

THE AMERICAN COUNCIL OF LIFE INSURANCE

BEFORE THE

COMMITTEE ON BANKING AND FINANCIAL SERVICES

ON

H.R. 10, THE FINANCIAL SERVICES ACT OF 1999

FEBRUARY 10, 1999

Statement made by:
Mark A. Pope
Vice President
Federal Government Affairs
Lincoln National Corporation

Mr. Chairman and members of the Committee, my name is Mark Pope. I am Vice President and Director of Federal Government Relations for Lincoln National Corporation, located in Fort Wayne, Indiana.

I am appearing today on behalf of the American Council of Life Insurance, the principal trade association for the nation's life insurance companies. Its 493 member companies account for approximately 80 % of the life insurance in force in the United States and 85 % of the insured pension business. We appreciate the opportunity to present the industry's views on H.R. 10, the Financial Services Act of 1999.

Mr. Chairman, at the outset we want to applaud your tireless efforts to keep financial modernization legislation moving forward. Without the type of leadership and commitment you have shown to keep this issue on track, the process would be at dead stop. We are greatly encouraged by your dedication and look forward to working with you and other members of the Committee to see this legislation through to the President's desk.

There Is Strong Support for H.R. 10

For most of the last twenty years, as the various components of the financial services community battled over the predecessors to H. R 10, you, as well as previous chairmen of this Committee and its Senate counterpart implored us to put aside our parochial differences and seek common ground. The goal then as now was to produce a fair compromise which would allow broadened competitive opportunities, a level playing field in a regulatory sense, and adequate protection for consumers.

Last year, building on the foundation produced on a bi-partisan basis by this Committee under your leadership, the principal trade groups representing insurance companies, agents, banks, and securities firms joined in an historic agreement to support H.R. 10 as it had been reported from the Senate Banking Committee, together with consensus provisions that were to have been part of a Manager's Amendment for the Senate floor.

Time ran out on that attempt to bring that bill to the President's desk. Fortunately, however, the agreement between the affected industries remains intact and has been embodied in H. R. 10 as reintroduced this year. The bottom line is that we support it as introduced. It isn't perfect from anyone's perspective, nor is it necessarily the only way to accomplish needed reforms. However, it is fair, and it is the only financial modernization

proposal - *ever* - which has had the broad industry support necessary to achieve enactment.

The principal provisions of H.R. 10, such as those relating to insurance, were painstakingly developed over the last two years as the predecessor bill tortuously made its way through this Committee, the Committee on Energy and Commerce, and the Senate Banking Committee. To describe this language as sensitive is a dramatic understatement. Almost every provision was the product of extensive debate among insurance companies, agents, regulators and others. For every provision that was agreed upon, a dozen or more others were considered and rejected. For that reason, departures from the insurance language of H.R. 10, no matter how seemingly minor or how well-intended, raise a substantial risk of upsetting the delicate balance achieved last year. Opposition from any major segment of the financial services industry could drastically reduce the prospects for legislation in this session, a situation we certainly wish to avoid.

We understand that the committee has to work its will on H.R. 10. However, as you do, please to bear in mind that an agreement that has been sought for twenty years is there for the taking. It would be a shame to lose sight of how much was accomplished last year or to inadvertently unravel the broad coalition which supports H.R. 10 in its current configuration. There is nothing to be gained by further delay and much to lose. Dynamic

changes in the market will continue. If these changes are not guided by a comprehensive modernization plan, the result will be regulatory anomalies and competitive inequities which will make any future consensus that much more difficult to achieve. Now is the time to act, and H.R. 10 is the appropriate vehicle.

Why Insurers Support Legislation

There is often misunderstanding of the reason for insurance company support of financial modernization legislation. Often we have been asked why we do not support bare-bones proposals to simply repeal statutes which prevent widespread affiliation between banks, securities firms and insurers. Our response is that the vast majority of insurers are not seeking the ability to affiliate with commercial banks. Insurers desiring to have banking capabilities have had since the 1960's the authority to affiliate with thrift institutions and have always been able to affiliate with securities firms.

Our principal reason for supporting modernization legislation is to assure that an increasingly integrated and complex financial services industry is regulated fairly and effectively. Our goal has not been to secure any special treatment or advantage for insurers, but rather to make certain that if banks choose to enter the insurance business they will be subject to the same statutes and regulations that insurers not affiliated with banks must observe. It is this concept that is embodied in H.R. 10.

Key Insurance Provisions of H.R. 10

There are 5 critical provisions for life insurers contained in H.R. 10. Each must be part of any legislation that is to have the support of our membership:

- **Requirement that insurance be functionally regulated by the States** — Equal regulation is perhaps the best guarantor of competitive equality. How an insurer is regulated should not be dependent on whether or not it is affiliated with a depository institution.
- **Definition of insurance** — The purpose of the insurance definition is not to deny any activity to banks, but to make clear what the dividing line is between insurance and other financial activities for regulatory purposes. One of the main concerns of insurers has been the propensity of some federal banking regulators to characterize virtually anything an insurer does as "part of or incidental to banking," and, thus, arguably beyond the full jurisdiction of insurance regulators. For that reason, it is not sufficient for legislation to simply require "functional" regulation of insurance. Without a definition, a particular product could be determined to be "insurance" when provided by an insurer, but "banking" when provided by a bank. In combination with the prohibition on underwriting anywhere but in an insurance affiliate of the holding company, the definition effectively requires all traditional insurance underwriting activities to be conducted in insurance affiliates subject to State regulation.

- **Equal deference —** There is a clear need for a mechanism for fairly resolving disputes between regulators over the classification of new products with insurance characteristics. This mechanism must ensure that relevant regulators' views are afforded equal weight and that no particular regulator's views are always controlling.
- **Prohibition on insurance underwriting in an operating subsidiary of a bank—** Insurers have insisted on this provision to prevent banks from making use of any capitalization advantage attributable to the federal safety net, to minimize the likelihood of state laws governing insurance underwriters being inappropriately preempted and to prevent financial impairment of insurance subsidiaries resulting from least-cost-resolution requirements on parent banks.
- **Mutual redomestication provisions** -- This provision affords mutual insurance companies the ability to reorganize in a form that permits them to raise capital through the sale of stock and thereby remain competitive in the emerging diversified financial marketplace such language is highly desirable. In substance, this language permits mutual insurers to redomesticate to states in which the formation of mutual holding companies are permitted.

Areas for Improvement

While we are squarely behind the major provisions of H.R. 10 , we believe there are a number of areas in which it may be significantly improved without disturbing the consensus for its enactment. Some of these changes are technical in nature, while others are intended to provide added flexibility for insurance companies and their regulators to operate in an integrated financial services environment.

- **Change of Control** -- Currently, state insurance regulators are charged by law in all jurisdictions with the responsibility for protecting the interests of policyholders whenever there is a change in control of an insurance company. In this context, policyholder interests can be affected by any number of factors, including: the effect of the transaction on the insurer's capital; the capital position of the acquirer; the nature of the proposed financing; the prospective new parent's business plan for the insurer; the capability of management of both the insurer and its prospective new parent; and so on.

  Under current law, state insurance regulators have broad authority to approve, disapprove, or condition a transaction under which control of an insurer would change. H.R. 10 would radically diminish the states' authority in this regard, providing that only the Federal Reserve Board would be in a position to

disapprove an insurer/bank affiliation transaction. State regulators would be still be entitled to notice of the proposed change in control, would still receive largely the same information on the transaction that they would under current insurance holding company statutes, could still require that the acquiring bank maintain the insurer's capital at a high level, and could continue to deal with receiverships and conservatorships. Beyond these things, however, an appeal would have to be made to the Fed if state insurance regulators were of the view that the transaction would not be in policyholders' best interests.

Our concern here is that H.R. 10 as drafted contains no guidance or explicit statutory authority directing the Fed to consider the merits of such appeals from state regulators. If the Fed is to be given this extremely broad role of "umbrella regulator," then we believe it is absolutely essential that the law require the agency to consider a number of specific factors when it finds itself in the position of reviewing an insurer/bank affiliation.

The lack of any standards or benchmarks in the insurance context stands in stark contrast to the Fed's role in approving or disapproving a transaction under which a non-depository firm proposes to acquire control of a bank. There, H.R. 10 is replete with provisions on the agency's authority and responsibility for assuring

the financial integrity of banks and their parents, protecting the deposit insurance funds, and protecting depositors.

We believe that H.R. 10 should be amended to provide that the Fed must solicit the views on such an affiliation transaction from the insurance regulator in the insurer's state of domicile and that, in reviewing the transaction from the perspective of the best interests of policyholders, it must consider whether: (i) the acquisition of control would tend to affect adversely the contractual obligations of the insurer or its ability to render service in the future to its policyholders; (ii) the financial condition of any acquiring party is such as might jeopardize the financial stability of the insurer or of any company or entity controlling such insurer, or prejudice the interests of its policyholders, (iii) the plans or proposals which any acquiring party has to liquidate the insurer or any such controlling company or entity, sell its assets or consolidate or merge it with any person, or to make any other material changes in its investment policy, business, corporate structure, or management are fair and reasonable to policyholders of the insurer, and (iv) the competence, experience, and integrity of those persons who would control the operation of the insurer are such that the acquisition of control would not tend to affect adversely the general capacity or intention of the insurer to transact the business of insurance in a safe and prudent manner. The Fed should also consider

any information or recommendation furnished to it from the insurance regulatory authority of any state where any insurance company that is the subject of an acquisition of control is domesticated, whether such information or recommendation is based on the information furnished in accordance with Section 104(a)(2) or otherwise.

- **Downstream Investments of Insurers** -- Section (c)(3)(I) of new Section 6 of the Bank Holding Company Act is an important aspect of H.R. 10 from the standpoint of the ACLI membership. It recognizes that insurers may affiliate with depository institutions as part of a financial holding company and at the same time retain their downstream portfolio investments made in the ordinary course of business and in accordance with applicable state insurance investment laws. The debt and equity portfolio investments of insurance companies are diverse, and often as not consist of securities of industrial, nonfinancial, entities. In some cases, these investments represent controlling interests. In drafting H.R. 10, it was recognized that it would be both impractical and pointless to require insurers wishing to affiliate with banks to limit or dispose of their traditional commercial investments.

  Unfortunately, the draft adds a further limitation that, in our opinion, is both problematic and unnecessary. That limitation provides that the financial holding

company may not directly or indirectly participate in day-to-day management of a company (i.e., an insurer's portfolio investment in a company in which the insurer has a controlling interest) except insofar as is necessary to achieve the objectives of this provision of the bill. By use of the word "indirectly," the limitation on active management apples to the insurance company itself (as it would as well if the insurer itself were the bank holding company).

State investment laws do not prohibit insurers from having controlling interests in nonfinancial, commercial firms. Those laws do, however, severely constrain the size of such investments. For example, the investment laws in all states limit an insurer's investment in downstream insurance subsidiaries to a small percentage of the insurer's assets, and further limit investments in non-insurance subsidiaries. Moreover, the current standards in all states for valuing investments in subsidiaries operates to imposes risk-based capital constraints that are usually more limiting than quantitative investment provisions.

The net result is that insurers' commercial portfolio investments made in the ordinary course of business and subject to state investment and risk-based capital constraints and not large enough to warrant the further limitation on active management. Indeed, preventing active management is not in the best interests of

insurance policyholders because it may diminish the performance of the portfolio and consequently the economic benefits to policyholders. For these reasons, we urge that the language on day-to-day management be deleted from the bill in this limited circumstance.

- **Safe Harbor Provisions** -- Many of the 13 items contained in the so-called "safe harbor" relating to state regulation of insurance sales by banks [section 104(b)(2)(B)] unintendedly extend bank sales restrictions to affiliated insurance companies and their agents acting totally independently of the bank. These provisions should be modified to apply only to sales activities conducted by employees of the bank, on the premises of the bank, or at the recommendation of the bank.

In section 104(b)(2)(B)(viii), there is a cross reference to section 106 of the Bank Holding Company Act which has the unintended effect of preempting state anti-rebate laws for bank-related sales of insurance products bundled with deposit products. This creates a severe competitive imbalance for sellers of insurance not affiliated with banks who must comply with the state law. This provision should be removed from the bill.

Conclusion

In closing , we would only add that the need for this legislation is clear; the principal provisions are not in dispute; and there is no rationale for further delay. All that remains is for Congress to vote. Here is an opportunity for Congress to enact historic legislation on a bi-partisan basis that has broad support among all the affected parties— a win-win proposition if you will. We look forward to working with the Chairman and the other members of the Committee to complete the finishing touches on H.R. 10 and send it to the House floor.

STATEMENT OF THE AMERICAN INSURANCE ASSOCIATION

Testimony of Harry Rhulen,
Chairman, President & Chief Executive Officer
Frontier Insurance Group, Inc.
On behalf of the
American Insurance Association
On
Financial Services Reform and H.R. 10 the "Financial Services Act of 1999"

Before the
Committee on Banking and Financial Services
U.S. House of Representatives

February 10, 1999

American Insurance Association

The American Insurance Association is a national trade organization of property and casualty insurers.

Statement of the American Insurance Association on Financial Services Modernization

Good morning Mr. Chairman Mr. Chairman and Members of the Committee. My name is Harry Rhulen, and I am Chairman of the Frontier Insurance Group in Rockhill, New York. I am delighted to be here this morning on behalf of the member companies of the American Insurance Association ("AIA").

AIA is a trade association representing more than 300 insurance companies which write a large portion of the property/casualty insurance sold in the U.S. and in the global marketplace. I appreciate the opportunity to offer AIA's views as to the content of federal financial services modernization legislation, particularly as it relates to H.R. 10, the Financial Services Act of 1999, introduced on January 6.

AIA has a vital interest in the modernization of the U.S. financial sector, and we have been strong supporters of H.R. 10 since the original version of the legislation was reported out of this Committee in June of 1997. It is a historic measure that rationalizes the archaic laws which now govern our nation's banks, securities, and insurance firms. If enacted, it would provide new opportunities for all financial services providers, increase the financial services options available to consumers, and improve the international competitiveness of U.S. financial services firms. We would like to commend Chairman Leach, and the Members of this Committee, for the steadfast leadership you provided to H.R. 10 throughout the 105th Congress, and for making this legislation a top priority for the 106th Congress.

H.R. 10 makes substantial progress toward reconciling the disparate regulatory systems that now govern insurance companies, depository institutions, and securities firms, and in establishing a level playing field among all financial services sectors. As you know, the current bill is the product of a two-year debate among a multitude of Congressional committees, federal and state regulators, and financial services firms. During this long debate, compromises were made by every participant. As a result, while not perfect from the perspective of any participant, H.R. 10 creates a legislative and regulatory system that fairly balances the economic concerns of the various industry groups, while recognizing the critical importance of solvency and consumer protection. We appreciate the opportunity to be part of this process and welcome the opportunity to work with you as H.R. 10 moves forward.

H.R. 10 in the 105th Congress

AIA testified before this Committee in April of 1997, expressing our support for financial services modernization. Our view was then, and is now, that federal legislation is urgently needed to establish a rational statutory framework to guide the financial

services sector into the 21st century. Absent the prompt enactment of such legislation, Congress will continue to cede its responsibility in this area to ad hoc regulatory decision making and court decisions.

Back in early 1997, many political observers were skeptical as to whether Congress could break a twenty-year deadlock on financial services modernization and enact comprehensive legislation. Despite this skepticism, you moved ahead. Under your leadership, H.R. 10 proceeded further than many thought possible and attracted bipartisan support in both the House and the Senate. As you are well aware, it failed in the Senate as a result of severe time constraints that blocked its progress to the Senate floor in the closing days of the last session. We believe that if even a little more time had been available, the few open issues would have been resolved, and H.R. 10 now would be law. And mindful of the time constraints that plagued the legislation last year, we are extremely pleased that you introduced the current version of H.R. 10 on the earliest possible day of this session, in order to provide ample time to debate the open issues and assure that the enactment of financial services modernization is among the significant accomplishments of the 106th Congress. We applaud your past role in advancing H.R. 10 and look forward to your continued leadership in the drive to enactment in the 106th Congress.

AIA is proud that we were among the first to support H.R. 10 during the 105th Congress. However, we were far from alone. By the end of the last session, the measure was endorsed by virtually all of the affected industry groups from the insurance, banking, and securities sectors. In arriving at this consensus, compromises were made by virtually every participant in the debate. The newly introduced version of H.R. 10 reflects these compromises well. While we recognize that certain changes to the bill are likely this year, we urge you to maintain the bill's overall balance so that it will continue to enjoy the same broad support. Maintaining this balance is more than a matter of political expediency—it should be done because the principles of H.R. 10 are the *right* principles for fair and effective financial modernization, as discussed below.

Key Issues

AIA believes that successful integration of property/casualty insurance into the framework of H.R. 10 depends on the resolution of several key issues. The bill that is now pending before the Committee appropriately resolves most of these issues, but we offer a few suggestions for your on-going consideration.

Federal Legislation Must Establish a Viable System of Functional Regulation

1. Insurance Regulators Must be Authorized to Define "Insurance."

AIA believes strongly in the principle of functional regulation, through which federal bank regulators oversee bank products, and state insurance regulators oversee

insurance products. In order to create a viable system of functional regulation, it is critical to establish an appropriate process for defining both "banking" and "insurance." These definitions, and the process for resolving disputes about them, received considerable attention during the 105th Congress.

The new version of H.R. 10 represents a fair compromise between the regulatory and private sector interests at stake. This compromise definition was the result of extensive and intensive discussions among banking and insurance representatives. On the insurance side, it preserves state insurance regulators' authority to define existing insurance products, and most insurance products offered in the future. Banks, on the other hand, retain the ability to offer any banking or insurance product that they were authorized to offer, or were in fact lawfully providing, as of January 1, 1997. Banks also are authorized to provide new products that are letters of credit or similar extensions of credit, qualified financial contracts or financial guarantees, or other new deposit, loan, and trust products as long as such deposit, loan and trust products are not treated as insurance under the Internal Revenue Code.

The insurance definitions of H.R. 10 provide the critical foundation for functional regulation. Moreover, they do *not* restrict the extent to which banks can affiliate with insurance companies and thus underwrite insurance products that are properly subject to state insurance regulation. It is important to emphasize the very limited nature of these definitional provisions:

First, they do *not* preclude a bank from selling (as an agent) any insurance product but merely address bank insurance underwriting (as principal).

Second, they do *not* affect a bank's ability to underwrite insurance products, such as credit life insurance, that banks were authorized to write or were in fact lawfully writing as of January 1, 1997.

Third, they do *not* affect a bank's ability to offer traditional banking products, and new forms of banking products, such as letters of credit or similar extensions of credit, or qualified financial contracts and financial guarantees.

Fourth, they do *not* prevent banks from offering any insurance product in an insurance company affiliate appropriately licensed and regulated by the state insurance regulators. Any insurance products can be underwritten by banking organizations as long as this activity is conducted in a separate affiliate.

These provisions of the bill are, however, designed to prevent banks from underwriting new insurance products that are not subject to insurance regulatory oversight as a result of a determination by the Comptroller of the Currency that such products are not insurance because they constitute "banking" or are "incidental to the business of banking." The Comptroller must not ignore the principle of functional regulation by redefining banking to include insurance products, and thus making

insurance underwriting permissible for banks without appropriate insurance regulatory oversight.

2. Dispute Resolution Standards and Procedures Must be Fair.

Under any definitional scheme, disputes between the OCC and state insurance commissioners may arise as to whether a particular product is "insurance" or "banking." If such disagreements arise, there must be a fair means of resolving disputes that preserves the tenets of functional regulation.

H.R. 10 provides that disputes between regulators will be decided by the federal courts on the merits, without unequal deference to either party. It has three main elements:

First, subject to a reasonable statute of limitations, banking and insurance regulators have the opportunity to challenge an adverse product definition determination by another regulator. The financial community needs to have certainty that, after an appropriate period of time, their product offerings cannot be challenged. On the other hand, some regulatory actions regarding the definition of a particular product and the resulting authority of an institution to offer a new product are not widely disseminated. Adequate time must be available to learn about such regulatory decisions. The bill strikes a reasonable balance between these two interests.

Second, federal courts must decide all disputes on an expedited basis and on their merits, using criteria spelled out in the bill. An expedited review procedure is necessary to avoid unnecessary delays, which could impede a financial institution's ability to respond to dynamic market conditions.

Third and most importantly, courts are to grant no unequal deference to either federal or state regulators. This is critical because, under the *Chevron* doctrine, the courts routinely uphold interpretations and other actions of the Comptroller of the Currency ("OCC") relating to national banks. The *Chevron* doctrine provides that, when a court reviews a federal agency's interpretation of a statute it administers and the statute is silent or ambiguous, the court should not impose its own construction of the statute. Rather, a court should defer to the agency's reasonable interpretation of the statute, even though the court might come to a different conclusion if it were to review the statute *de novo*.

Applying the *Chevron* doctrine to the definition of the term "insurance" in the context of the insurance powers conferred by H.R. 10 is inappropriate in view of the manner in which the legislation strikes a balance between state and federal authorities. H.R. 10 defines "insurance" in terms of products that are determined to be insurance under state insurance law, unless the OCC determines that the product is a traditional banking product. Although incorporation of a state law definition of insurance into federal banking statutes is unique, use of a state's definition is correct, in recognition of the longstanding role of the states in regulating the business of insurance. Because H.R. 10 incorporates the state's definition of "insurance" into federal law, it would be highly

inappropriate to defer to the OCC's view as to what is essentially a matter of interpretation of state law. By providing that in a challenge brought by a state insurance regulator, a court should give equal deference to the views of the OCC and the state regulator, H.R. 10 strikes the right balance between the authority of the OCC as the supervisor of national banks and the historic role of the states in regulating insurance at the local level. It also reflects the principle of functional regulation which underlies the legislation.

With regard to the relationship between federal and state law more generally, we support the provisions in the current draft that recognize the long-standing policy that state law should control issues relating to corporate governance of state chartered institutions. Specifically, Section 104(a)(3) provides that the statute will not be interpreted as preempting state corporate governance and antitrust laws. In certain instances, however, states have chosen to develop separate chapters of their state codes that apply exclusively to the corporate governance of certain regulated industries, such as insurance. We believe that Section 104(a)(3) should be read to cover state laws relating to corporate governance of a particular industry, and that any potential ambiguities in this regard should be clarified as the bill moves forward.

Federal Legislation Must Protect the Safety and Soundness of the Insurance Industry

The safety and soundness of the insurance industry are critically important to American families and firms. Property/casualty insurers sell a unique and vital product--the promise to pay the costs associated with a wide range of unanticipated occurrences, including automobile crashes; fire, theft, and windstorm; workplace accidents; and liability judgments. To fulfill this promise, insurers must be adequately capitalized, properly managed, and effectively regulated. Federal financial services modernization legislation must not impede state insurer solvency regulation, or put the solvency of the insurance industry at risk. In particular, the legislation must not enable banks or bank regulators to tap resources of insurance companies and the state guaranty funds.

We believe that financial services modernization legislation must place the safety and soundness of insurance companies on par with that of depository institutions. It should avoid impairing insurance companies and state insurance guaranty funds in order to bolster the financial condition of depository institutions and the federal deposit insurance funds. We commend the Federal Reserve Board for acknowledging this important objective and are pleased that H.R. 10 incorporates language on this important issue.

In this regard, the bill contains provisions to assure that the Federal Reserve Board will not unilaterally require insurance company assets to be used as a "source of strength" for banking operations. Instead, the Board will notify the domiciliary state insurance commissioner prior to requiring the transfer of resources from an insurer to an affiliated bank, and defer to the insurance commissioner if he or she makes a

determination that such transfers would have a material adverse effect on the financial condition of the insurer in question. In such a situation, the Board is authorized to require the bank holding company to divest the bank but cannot force financial transfers that would imperil the insurance company and place state guaranty funds at risk.

As a related matter, we support the so-called "Fed lite" provisions. Under these provisions, the Federal Reserve Board generally is prohibited from regulating an insurance company affiliate of a bank, unless doing so is necessary to address an unsafe or unsound practice or breach of fiduciary duty by the insurance company, that poses a material risk to the bank or the domestic or international payment system. We also support provisions in the bill relating to consultations between banking and insurance regulators concerning financial holding companies that include both bank and insurance affiliates.

Federal Legislation Must Place Insurers and Banks on a Level Playing Field

Federal financial services legislation must create a level playing field for banks and insurers. This can be achieved only if several conditions are met. First, as a practical matter, insurance companies must be able to acquire banks. Second, any financial or regulatory advantages inherent to banking must be neutralized for banks acquiring insurers. Third, insurers and banks that are affiliated with each other must be treated the same as their counterparts that do not engage in such affiliations.

1. Federal Legislation Should Permit Insurers to Affiliate with Banks, Subject to State Regulatory Oversight

As a practical matter, insurers must be to acquire banks. In the past and at present, a number of major property/casualty insurers own, are owned by, or are affiliated with a wide range of commercial entities, including major corporations in the retail, industrial, and entertainment industries. These affiliations help property/casualty insurers to diversify their risks and reduce the volatility of their earnings. For example, the insurance risks associated with natural catastrophes generally are uncorrelated with financial or economic cycle risks facing other industry groups. Similarly, workers' compensation insurers may face more claims and higher losses during a period of economic expansion and increased industrial production. In view of these relationships, the legislation must permit insurers who wish to affiliate with banks to retain the ability to own, be owned by, or affiliate with commercial firms.

H.R. 10 recognizes that, unlike commercial concerns generally, insurance companies are subject to extensive financial regulatory oversight. The Model Insurance Company Holding Company Act, which has been approved in substantial part by every state, requires that changes in the control of a property/casualty insurer must be approved by the domiciliary insurance commissioner. In addition, state investment laws adopted

by most states require regulatory approval of insurance investments in most commercial enterprises if such investments exceed a specified percentage of a carrier's assets or surplus. These requirements provide insurers the flexibility to affiliate with a wide range of commercial entities, while fostering the safety and soundness of the insurance carrier. In deference to the state regulatory role in this area, H.R. 10 exempts commercial firms owned by insurance companies, in the ordinary course of their business and in accordance with relevant state laws governing such investments, from the broader commercial affiliations restrictions in the legislation. Regardless of the approach ultimately adopted with regard to broader affiliations between banks and commercial enterprises, these provisions should be retained in the legislation.

As a related matter, as you are aware, several insurance companies either own a savings association or have an application pending with the Office of Thrift Supervision to become a savings and loan holding company. We appreciate the new provision of H.R. 10 which permits any company that is engaged only in financial activities to become a savings and loan holding company by establishing or acquiring a savings association. This should provide continued flexibility to insurance companies which desire to offer financial services through alternative delivery channels.

This provision, however, does not fully address all of the companies that have decided that a savings association subsidiary is an important element in their business plans and have filed applications for savings association charters. H.R. 10 provides a "grandfather" for companies that filed applications for savings association charters by October 7, 1998. Certain companies that have applied for a savings association charter after this date would not qualify as financial holding companies. It is unfair to penalize these companies that have gone to considerable effort and expense to file their applications at a time when the it was clear that H.R. 10 would not be enacted during the 105th Congress. Accordingly, we recommend that the grandfather date in Title IV be moved to cover applications pending on the date of enactment of H.R. 10 during the 106th Congress.

2. Insurers Affiliated with Banks Should Not Have a Competitive Advantage

AIA believes that the legislation must isolate the financial and regulatory advantages inherent to banking, and assure that these advantages are not transferred by a bank to an insurance company affiliate. Bank regulators and regulatory experts agree that, due to such factors as access to federal deposit insurance and the Federal Reserve's discount window, banks enjoy a gross funding subsidy compared to other financial institutions. There is disagreement, however, as to whether banks receive a net subsidy after offsetting costs such as reserve requirements, regulatory expenses, and regulatory restrictions are taken into account.

The question of whether banks enjoy a net as well as a gross subsidy is largely irrelevant when comparing banks to property/casualty insurers. Property/casualty insurers are subject to a wide range of state regulatory restrictions—including reserve

requirements, investment limitations, rate and form approval requirements, guaranty fund charges, and residual market burdens--without offsetting subsidies such as those provided to the banks. The cost of regulatory compliance for property/casualty insurers is arguably higher than that for banking organizations.

By requiring new insurance underwriting activities to be conducted through an affiliate of the bank (rather than in a subsidiary), H.R. 10 largely addresses this subsidy advantage. We support the bill in this regard. We recognize, however, that the Federal Reserve and the Treasury Department are still at odds over whether banks should be permitted to engage in certain new financial activities, such as insurance underwriting, through operating subsidiaries, or only through holding company affiliates. Any changes to H.R. 10 need to be carefully analyzed in order to make sure that they do not give bank-owned insurers an advantage over other insurance companies.

3. All Banks and Insurers Should Have the Same Rights and Responsibilities, Regardless of Affiliation

Banks that are affiliated with insurers should enjoy all of the rights and privileges of banks that are not so affiliated, including non-discriminatory access to the Federal Reserve's payment services and credit facilities. At the same time, insurers that are affiliated with banks should not be accorded a favored position relative to insurers that are not affiliated with banks. A bank-affiliated insurer underwriting property/casualty insurance must be subject to relevant state regulatory requirements and required to participate in all relevant state insurance residual markets and guaranty funds on an equal basis with other property/casualty insurance underwriters.

By embracing the concept of functional regulation, H.R. 10 helps to assure that banks and insurance companies are on equal footing in the marketplace. Provisions designed to result in a balanced definition of "banking" and "insurance" will ensure that banks cannot offer insurance products free from state regulatory requirements.

Federal Legislation Should Include Appropriate Consumer Provisions

Banks and insurance companies are among the most heavily regulated businesses in the United States. Banks are subject to "cradle to grave" regulation by federal bank regulatory authorities. Insurers are subject to a myriad of state regulations in every state in which they write policies. To assure the protection of consumer interests, current federal banking law contains numerous consumer protection provisions, including disclosure requirements and prohibitions on coercive tying arrangements. Similarly, state insurance codes contain a wide variety of consumer protection provisions, including antitrust provisions and unfair practices laws.

AIA supports the inclusion of appropriate consumer protection provisions in H.R. 10. Given the broad scope of existing federal and state banking and insurance consumer protections, we oppose the imposition of burdensome and unnecessary mandates simply to impose a "quid pro quo" for financial services modernization.

In this regard, we are particularly concerned about the promulgation of new privacy mandates, such as those contained in S. 187 (the Financial Information Privacy Act of 1999). This bill would restrict the ability of covered financial institutions to share specified customer information with affiliates, unless the customer is provided "opt out" rights and impose even more restrictive "opt in" requirements on financial institutions which wish to share customer information with non-affiliated business partners. These privacy restrictions would serve to disadvantage consumers in that they would inhibit product and service innovation and diminish the competitiveness of financial services providers. Moreover, the experience of banks subject to similar requirements under the Fair Credit Reporting Act is that they are expensive and operationally difficult to implement. Ultimately, we believe that the new restrictions are unnecessary, in that the customer ultimately makes the decision of whether to "opt in" or "opt out," in terms of purchasing a financial product or service that is offered in the market.

The Legislation Should Include a New Regulatory Association for Agents and Brokers

H.R. 10 would create a National Association of Registered Agents and Brokers (NARAB), intended to provide an incentive for states to standardize licensing procedures for insurance producers. NARAB will enhance the efficiency of state-licensed insurance producers who provide services to customers in multiple jurisdictions. AIA member companies provide coverage for a wide range of commercial customers who are involved in multi-state transactions. NARAB would improve our ability to provide such coverage in a timely and cost-effective manner.

We are aware that concerns about NARAB have been expressed by the state insurance regulatory community. In fact, the NARAB provisions would go into effect only if states do not take needed action to facilitate interstate insurance transactions. Moreover, control of NARAB's Board of Directors would be in the hands of state insurance regulators. We believe that NARAB advances the goals of financial services modernization, while respecting the role of the states as the primary regulator of insurance activities.

Conclusion

AIA strongly supports the enactment of financial services modernization by the 106th Congress. It will update obsolete federal laws governing financial services and set up new "rules of the road" for affiliations involving the banking, insurance, and securities industries. H.R. 10 strikes a fair and appropriate compromise between regulatory, the private sector, and consumer interests involved in this debate. We urge you to move ahead as quickly as possible.

The Council of Insurance Agents & Brokers

Statement of

James J. Kilbride

Chairman & CEO

Morse, Payson & Noyes Insurance (Portland, ME)

on Behalf of

The Council of Insurance Agents & Brokers

Testifying on

The Financial Services Act of 1999

Before The

U.S. House of Representatives
Committee on Banking and Financial Services

February 10, 1999
Washington, D.C.

I. The Functional Regulation of the Business of Insurance Should be Left to the States

As an initial matter, this Committee should reiterate that every entity that engages in the underwriting or sale of insurance is bound by State laws that regulate those activities. Because no insurance licensing and regulatory scheme exists at the federal level, the only available regulators of the participants in the insurance industry are the States themselves. However, national banks appear to believe that they are exempt from at least some of the governing insurance regulations in States in which they are currently engaging in the business of insurance. Although the Office of the Comptroller of the Currency ("OCC") has recognized that State laws generally apply to national bank sales of insurance, it also has emphasized that national banks need not comply with State laws that interfere with their activities. Without the creation of a federal regulatory authority or a reaffirmation of the absolute right of States to regulate such insurance activity, the scope of this "exemption" will remain unsettled and national banks may be free to engage in the business of insurance without significant oversight.

Any such result would be particularly problematic. Allowing some entities -- such as national banks -- to be protected from State regulation in this area, while continuing to require all other participants in the business of insurance to be fully subject to the full panoply of state insurance regulation, would create a lopsided marketing environment. This would heavily favor national bank efforts to make in-roads into the insurance agency arena. Reaffirming the right of States to regulate the insurance business is thus necessary to avoid this result, as well as to ensure that all entities engaged in the insurance business are subject to effective consumer protection requirements and to ensure that the insurance-buying public has consistent assurances of quality. Given the sophisticated insurance licensing and regulatory structure developed exclusively at the State level over the past 200 years, it is apparent that such interests are best protected at the State level.

Moreover, any such reaffirmation would not be new or radical. To the contrary, it merely would build upon and clarify a federal policy that has been in place for over 200 years that States have virtually exclusive regulatory control over the insurance industry. Indeed, until 1944 it was universally understood by everyone (including Congress) that Congress has no constitutional authority to regulate the business of insurance. This changed with a single Supreme Court decision issued that year. Congress responded immediately by enacting the McCarran-Ferguson Act, which "restore[d] the supremacy of the States in the realm of insurance regulation."[1]

McCarran's statement of federal policy could not be more clear: "The business of insurance, and every person engaged therein, shall be subject to the laws of the several States which relate to the regulation or taxation of such business."[2] Given the States' historical expertise in the realm of insurance regulation, and the absence of any such expertise at the federal level, there does not appear to be any compelling reason for abandoning this traditional policy approach.

1/ United States Dep't of Treasury v. Fabe, 113 S. Ct. 2202, 2207 (1993).

2/ 15 U.S.C. § 1012(a).

II. The Need for a Uniform Licensing Mechanism

Although, as a general matter, The Council strongly supports continued state regulation of the business of insurance, it also believes that the needlessly duplicative regulatory requirements that are now imposed on agents and brokers who seek to do business in more than one State need to be drastically reduced. A recent survey of Council members revealed that complying with multi-state agent and broker licensing requirements is increasingly difficult and time-consuming. This trend is alarming, particularly in an economic climate that demands better and more efficient service to our clients. I believe that the inefficiencies of the licensing process are diverting valuable resources that should be directed towards providing better service to the customer.

To get a better grasp on the costs involved in licensing, which includes administrative expenses as well as fees, The Council conducted a follow-up survey of our members and asked them to estimate how much they spend a year on licensing. The responses to these questions were, by any measure, astounding. My own agency, for example, spends tens of thousands of dollars per year on the administrative costs associated with licensing. Other Council members reported spending more than $500,000 on administrative costs associated with licensing -- a figure that excludes the licensing fees themselves. Even by way of a rough extrapolation, it is easy to see that the current system imposes enormous costs. At a time when we are all trying desperately to reduce the cost of insurance, these figures should concern policy makers. Not only does the duplication of effort in each State add to our costs, but it also adds to the administrative overhead of every insurance department in the country -- resources that neither we nor the state departments can afford to waste. The problems that our members have with licensing have nothing to do with standards of professionalism. The fact is that the training and skills necessary to become a licensed insurance agent or broker are not particularly high in comparison to many other areas of professional endeavor. The procedural hoops through which successful multi-state agents and brokers must jump, however, are considerable.

Five years ago, The Council created a licensing division as a service to our members who wished to outsource much of the administrative aspects of agent/broker licensing. Currently, the division assists in the procurement of licenses for more than 250 brokerages -- handling approximately 7,500 separate licenses and 6,000 company appointments. It is not unusual for a single insurer producer to be required to obtain 100 licenses or more -- particularly if that agent or broker is engaged in forming national insurance programs for specific lines of insurance. Virtually every firm in the membership of our organization offers such national programs. Each license has its own unique requirements and renewal periods.

The tremendous magnitude of costs stems from the fact that agents and brokers must obtain separate licenses to act as insurance agents in each State in which they want to do business, and in most cases they must obtain a variety of credentials in each of those States.

For example, under current law in most States, independent agents must file for separate agent, broker and adviser licenses. In addition, different licenses in each of these categories are often required to sell different lines of insurance (for example, three licenses for property and casualty insurance (agent, broker and adviser) and three for life and health insurance). Notification documents (also referred to as "licenses") must be filed in many instances for each company with which the agent does business. This process is then repeated in each State in which they conduct business. Each State has different application forms, statutory requirements (such as bonds, countersignatures, references, fees, and even, in eight States, finger-printing), and different expiration periods for the licenses. Each State has its own requirements for company appointments and/or corporate licensing in addition to individual licensing. The continuing education laws are all different and each State has its own forms and regulations, including applications for courses, certificates of attendance, and hours required (anywhere from 6 to 40 hours annually). Credits are earned for mere attendance at continuing education classes, not for passing any examinations.

My firm has to maintain hundreds of separate licenses to be able to sell and broker the full panoply of insurance products nationwide. In addition, we also must file thousands of notification documents. In every other area but licensing we have been able to streamline our business in recent years. We now operate our firm with fewer administrative employees, while servicing more customers and writing more business. Yet these duplicative and expensive licensing and notification requirements only seem to have increased.

For many years, the National Association of Insurance Commissioners ("NAIC") has formally urged States to be consistent in their licensing practices. In 1991, the NAIC began development of a consolidated system for tracking agent and broker activities. If proper protections are assured, the database could facilitate regulators' efforts in protecting consumers from fraudulent activity. The creation of this system was the culmination of over 15 years of discussions within the NAIC. The NAIC's Producer Information Network promises to allow electronic interface for multi-state *applications*. This is a big step forward. But the application process accounts for only a part of the multi-state licensing hoops through which insurance agents and brokers must jump. For all the commendable efforts by the NAIC as an organization, the political will does not exist on a state-by-state basis to streamline the process and to eliminate protectionist statutes and regulations. In fact, it may be unrealistic and unfair to expect the states to unilaterally treat out-of-state agents and brokers fairly in the absence of a national framework for licensing.

The most unproductive state licensing-related laws have to do with residency. Some states, for example, have laws that make it illegal for a non-resident to solicit the sale of insurance to a resident citizen of that state. These non-solicitation rules are absolutely anachronistic and unjustifiable. In an era when the simplest of insurance transactions is interstate – if not international – American insurance sales laws should reflect the openness of competition. How can we argue to our trading partners that they should open up markets to American competition, when we have so many insidious barriers to competition ourselves? Given the national and increasingly global nature of complex insurance transactions, we believe that many of these state licensing statutes are *de facto* protectionism. The Council is an active participant in two

international associations -- one based in Europe, the other based in South America -- that bring together brokers from around the world. As we attempt to broaden international opportunities for our own members, our international colleagues constantly remind us that U.S. licensure laws are a considerable trade barrier of their own.

Even in states where such non-solicitation laws are not in effect, barriers to efficiency and competition exist. Some States require an out-of-state agent or broker to run advertisements in local newspapers to announce their intent to conduct business in their State. Other States don't allow agencies to do business unless the agency fully incorporates under its laws. The list goes on and on.

During the past two decades, the number of independent insurance agencies in the nation has dropped by more than 50 percent, from over 90,000 in 1975 to less than 40,00 independent agencies today. Most significantly, the big firms among the survivors are getting bigger, and the small firms are occupying less and less of the marketplace. These numbers have less to do with agents going out of business than they do with consolidation. The volume of cross-state-border transactions has risen proportionately -- if not exponentially -- with this consolidation of agency and brokerage activity. But during these years, absolutely no steps have been taken to relieve the needless duplication. As explained in more detail below, it is long past the time to address these issues. The necessity is especially evident when viewed against the backdrop of a world in which all members of the financial services industry are free to affiliate with one another.

The Financial Services Act of 1999 that this Committee is currently considering presents a unique opportunity to address these concerns. At the same time it could alleviate what would otherwise be one of the largest impediments to permitting the modernization of the financial services industry — a modernization that this Committee is seeking to foster through its consideration of the Financial Services Act of 1999.

III. An Outline for an Approach that would Implement a Uniform Licensing Mechanism

I believe that the creation of a uniform licensing mechanism that would be administered through a joint state and federal effort -- what Subtitle C of Title III denominates "The National Association of Registered Agents and Brokers" ("NARAB") -- is the best means through which to standardize the licensure process. Such a mechanism would end the inefficient and unnecessary licensing duplication that continues to impede commerce rather than help it. Authored by Rep. Sue Kelly, this title received significant bipartisan support throughout the 105th Congress as H.R. 10 worked its way through the House and the Senate Banking Committee. In particular, Reps. Bruce Vento and Carolyn Maloney were instrumental in its passage through this panel in 1997, and the provision was bolstered by an amendment from Rep. Carolyn Cheeks Kilpatrick. This section outlines the mechanics of the Title III NARAB proposal and explains how such a body would address the concerns discussed at length above.

First, I believe that the States should be given the initial opportunity to create their own uniform licensing regime. I believe that providing such an opportunity is appropriate in recognition of the continued primacy of state regulation of all aspects of the business of insurance. Indeed, by supporting the NARAB proposal, The Council is not advocating the displacement of state law, only the standardization of the licensing components of that state law. I also believe that many state regulators strongly support such uniformity. They have the requisite political will. The logistical impediments to negotiating a nationwide compact among 50 States, however, are obviously onerous. Because of this practical limitation, The Council believes that the opportunity for the States themselves to create a uniform licensing regime should be limited to three years.

As I have argued, there is an intense need for reducing the duplicative licensing qualification and application requirements. If the political obstacles to an efficient state-created system prove insurmountable, the initiative should be imposed by the one body that is best able to broker the necessary compromises -- the United States Congress. Specifically, States would be deemed to have established the necessary uniformity if a majority of them:

- Have established uniform or reciprocal criteria regarding the integrity, personal qualifications, education, training and experience of licensed insurance producers;

- Have established uniform continuing education requirements for licensed producers; and

- Do not impose any requirement upon any licensed producer that has the effect of limiting or conditioning that producer's activities due to the producer's residence or place of operations.

In short, States have a relatively low threshold to meet in order to avert the creation of NARAB. Rep. Rick Hill, a member of this committee, expressed a desire two years ago that the National Association of Insurance Commissioners be delegated the authority to run NARAB in the event that the threshold is not met. This idea is now embodied in H.R. 10 as introduced this year. If 26 states have not adopted reciprocal licensing statutes within three years, the NAIC will be afforded an opportunity to form and operate NARAB. Only in the event that the NAIC fails to do so after an additional two years would NARAB be formed as an independent agency. Even then, its governance would come from a board made up of a majority of state insurance commissioners. Specifically, Title III requires that more than 50 percent of the NARAB board be composed of NAIC members and that directors to that board could only be appointed from lists of approved candidates prepared and submitted by the NAIC.

The Council believes that the purpose of the actual licensing organization should be to provide a mechanism by which the multi-state services of state-licensed insurance producers may be more efficiently provided to policyholders, while preserving the right of states to license, supervise and discipline insurance producers. To this end, agents and brokers who opt to become members of

NARAB would still have to obtain licenses to conduct business on a state-by-state basis, and they would still have to pay the fees mandated by each State to receive those licenses. The licenses, however, would be obtained from, and the fees would be paid to, NARAB, which would then ensure that appropriate licensure applications are filed with, and the requisite fees paid to, each State from which NARAB members seek a license.

In other words, NARAB would function as a clearinghouse to allow efficient efficiently processing of multi-state license applications. In addition, NARAB members would be exempt from duplicative continuing education requirements and all residency requirements. NARAB would also be empowered to draft additional regulations under its general rule-making authority. States would then be prohibited from imposing any requirement upon a member of NARAB that is different than the criteria imposed by NARAB. NARAB would be empowered to define by regulation, subject to appropriate review, those state laws that have been preempted by the authorizing legislation. NARAB would be funded solely through membership fees paid by agents and brokers who opt to become NARAB members; the federal government would not fund the operation of NARAB in any way.

Under this proposal, all state-licensed agents and brokers would be eligible for membership on a strictly volunteer basis, but NARAB would have the ability to establish other reasonable membership criteria. Smaller agencies may not be unfairly limited in their access. NARAB would have the power to establish different categories of membership with separate membership criteria geared to the particular level of education, training and experience required by different agent and broker duties. Membership would be renewed annually, and NARAB would have the authority to bring disciplinary actions to deny, suspend, revoke or decline renewal of membership. The membership criteria for any NARAB member would meet and exceed the highest professional requirements that currently exist among States. NARAB would levy and collect assessments from members to cover administrative expenses.

NARAB would thus be given the authority to:

- Create a clearinghouse for processing insurance producer licenses, which would avoid duplication of paperwork and effort state-by-state;

- Issue uniform insurance producer applications and renewal applications that may be used to apply for the issuance or renewal of state licenses, while preserving the ability of each State to impose some conditions on the issuance or renewal of a license;

- Develop uniform continuing education standards and/or establish a reciprocity process for continuing education credits;

- Create a national licensing exam process; and

- Utilize a national database for the collection of regulatory information concerning the activities of insurance producers.

In reviewing this proposal, it is important to recognize the extent to which the State's regulatory control of the business of insurance will remain undisturbed. In the licensing context, the creation of the NARAB-type structure would not preempt state licensing fees or bond requirements in any way so long as those fees do not discriminate against NARAB members relative to non-NARAB members. States would be the actual net beneficiaries of NARAB creation because they would collect fees without having to perform the administrative function of licensing. Moreover, outside of the licensing context, NARAB would not affect any of the state laws and regulations that govern the business of insurance. These include those laws and regulations that govern the manner in which insurance must be solicited and sold, those that dictate the requisite contents of different categories of insurance policies, and those that bear more directly on insurer qualifications and licensure to do business. The overriding objective of NARAB would be to provide a uniform licensing scheme that ensures that high qualification standards and integrity are pervasive in the industry.

If the NARAB-type regime were put into place, State laws would not be preempted except in the following situations:

- No State could take action against a producer solely because he or she was a member of NARAB.

- No State could impose any requirements on NARAB members that have the effect of limiting activities because of their residency or place of operations including any requirement that a licensed producer be a resident of a particular State.

- No State could impose a requirement upon a NARAB member that deviates from a criterion for NARAB membership.

- No State could implement the procedures of its producer licensing system in a manner that is inconsistent with NARAB authority.

As might be apparent, NARAB is modeled on the National Association of Securities Dealers ("NASD"), an organization that was established pursuant to the Securities and Exchange Act of 1934. The NASD has primary regulatory responsibility for the day-to-day functioning of the over-the-counter securities market and for disciplining members in cases of misconduct. It also has the authority to inspect members and examine their books and records, as well as to prohibit fraudulent, misleading, deceptive and false advertising. For major transgressions, NASD has become a mechanism for feeding information about securities dealers to the SEC, which has the main responsibility for taking enforcement action.

Clearly, there are limitations to the parallels that may be drawn between the insurance and securities industries and between insurance producers and securities dealers. On the other hand, the references may be instructive. Since 1934, Congress, the SEC, the NASD, state regulators and private industry groups have worked together to identify and correct weaknesses in the securities markets. Through the creation and operation of NARAB, a similar arranged could be

developed for the insurance arena. Moreover, the creation of NARAB could help better assure policyholders that the agents and brokers with whom they may conduct business are well-qualified for the job. That is because NARAB would have the authority to set membership criteria for the personal qualifications, education, training, and experience of its members, and because those criteria may be focused and differentiated based on the particular duties that different types of agents and brokers perform.

IV. Responses to the NAIC's Objections to the NARAB Proposal

Although the NAIC would have a core role in the administration of NARAB -- from deciding whether it should come into existence at all to the fact that the NAIC itself would be afforded an opportunity to operate NARAB – the NAIC has objected to the initiative. The NAIC delivered a letter to Chairman Leach during this Committee's consideration of the Financial Services Competition Act of 1997 expressing concerns regarding several aspects of the NARAB legislation. A review of that letter, however, reveals that most of the concerns expressed by the NAIC are not based on a sound understanding of the proposed legislation.

First, the NAIC stated that this Committee had not received adequate testimony on this issue. In fact, the Committee heard testimony on NARAB in two separate hearings in 1997. Moreover, this proposal has been on the congressional table for seven years, and has received significant substantive attention. The members of this Committee have heard testimony on the proposal several times.

Second, the NAIC complained that NARAB would eliminate the ability of state regulators to deny license applications and "subsequently to suspend, revoke or place limitations on licensees in instances of inappropriate or illegal behavior on the part of the individual producer." Although the initial complaint is to some extent true -- NARAB would have the authority to establish uniform licensing requirements for its members -- the latter is not. States will continue to have the sole authority to discipline insurance producers for any and all violations of their insurance sales regulations (except for enforcement of their non-resident requirements) on NARAB members. NARAB would only affect its members' ability to be deemed qualified to sell insurance in such states. Moreover, the bill would require NARAB to base licensure requirements on the *highest* applicable standards maintained by any State.

It is very important to understand that when an agent or broker receives a license through NARAB from *any* State, he or she must first have received a license directly from his or her home State. No one may receive a license through NARAB without first being licensed in their own state. And in addition, all professional requirements for the various classifications of membership in NARAB must exceed the highest requirement of professionalism that exists in any state. These provisions make it absolutely clear that NARAB cannot become an escape from state standards; in fact, the opposite is true – NARAB members, by law, must meet a higher threshold of quality.

Third, NARAB would not, as the NAIC has previously suggested, create a "federal license" -- each state would issue a license to, and receive licensing fees from, any NARAB member who seeks to do business in that state. For this reason, almost all state insurance regulations, with the limited exception of pre-qualification and non-residency requirements, would continue to apply to all NARAB members. This would require NARAB members to comply with all "marketing restrictions, ethical restrictions, claim settlement practices and fiduciary requirements," despite the NAIC's suggestion to the contrary. Any laws that "allow for a remedy against an agent, broker or producer who places business with an insurer when that person knew or should have known that the insurer was insolvent or impaired" also would continue to apply in full to NARAB members. This is true despite the NAIC's suggestion to the contrary. NARAB has no impact whatsoever on the McCarran-Ferguson Act.

Fourth, the NAIC was correct in stating that the NARAB provisions do not impose any "standard of care upon insurance producers at the federal level." This, however, is not an effort to protect NARAB members from being subject to state laws that impose such requirements, and is instead intended to ensure such compliance. NARAB members will not be protected from consumer litigation in any way.

Fifth, the NAIC complained that Title III would create a self-regulatory organization run by "interested parties" and the NAIC implied that the decisions of those "interested parties will not be subject to review." Title III, however, requires that the governing body of NARAB -- the body that will determine the uniform requirements and licensing procedures -- must be controlled by state insurance regulators and any substantive provisions that they seek to impose are subject to review.

As explained above, other measures also have been included in an effort to protect the authority of state insurance regulators. Most significantly, Subtitle C of Title III now gives state regulators themselves three years to develop uniform licensing standards. If a majority of states do so, NARAB will not come into existence. If the states are unable to do so, however, the need for the creation of NARAB is essential.

Finally, the mere inclusion of the NARAB provisions in prior drafts of financial reform legislation has served to galvanize action in the States to streamline some processes. The NAIC's recent effort to urge its members to adopt a "uniform treatment standard" is probably the most visible example of such an effort. But that effort does not, as the NAIC has suggested, make the creation of NARAB unnecessary; indeed, it is instead emblematic of the continuing need for the creation of a national licensing clearinghouse.

As an initial matter, The Council applauds the NAIC's "uniform treatment" response to the potential enactment of the NARAB provisions. Under the standard the NAIC is promoting, however, the uniformity and reciprocity thresholds that would block the creation of NARAB would not be satisfied. This is because States that adopt a "uniform treatment" approach to licensing are not required either to adopt the same standards or to grant a license to a non-resident on a reciprocal basis. Instead, States that sign onto the NAIC's "uniform treatment"

agreement must simply apply the same licensure standards to all applicants regardless of whether they are residents of the State. Under this approach, however, each State is still permitted to impose different requirements on applicants for licensure and each State is still permitted to maintain a protectionist system if it so chooses as long as the same rules that apply to residents apply to non-residents. It would be perfectly permissible under the NAIC's uniform treatment policy, for example, for a State to require licensed agents and brokers to maintain an office in the State and to impose restrictions on the trade names under which their agencies sell and broker insurance products so long as the rules do not differ for residents and non-residents. Hence, many of the most damaging types of protectionist provisions such as those discussed above would remain unaffected under the NAIC's current "uniform treatment" regime. Even though that regime has its limitations, however, The Council does view it as a positive development. And, as discussed above, the structure of the NARAB provisions included in Title III includes great incentives for States to extend the uniform treatment approach to removing the many protectionist barriers to competition that still exist. If they are successful in that effort, then the need for NARAB would be averted and, under the Subtitle C, Title III provisions, it would not come into existence at all.

CONCLUSION

The Council urges this Committee to reaffirm that the primary regulation of the business of insurance for all entities who engage in that business should be left with the States. At the same time, The Council asks that this Committee take steps to alleviate one unfortunate -- and perhaps unintended -- ramification of such a delegation that will impose barriers to competition that any financial services modernization legislation would be designed to minimize. For this reason, The Council urges this Committee to pass Subtitle C of Title III of the Financial Services Act of 1999. NARAB would ease administrative and protectionist hurdles to licensure. NARAB would be beneficial to both the new affiliations that might be created as a result of the enactment of any financial services reform legislation as well as to the agents and brokers who already are trying to navigate through the morass of State licensing regulations. Without the removal of such unnecessary and damaging impediments to licensure, the public -- consumers, small businesses and large companies alike -- will continue to pay more for insurance coverage than they should.

The Council appreciates the opportunity to testify and present these views, and would be happy to provide any assistance that the members of this Committee believe may be beneficial as the Committee moves forward with its consideration of these issues.

NATIONAL ASSOCIATION OF
PROFESSIONAL
INSURANCE
AGENTS

Testimony of

DAVID O. CREIGHTON, SR.

Before the

Committee on Banking and Financial Services

U. S. House of Representatives

February 10, 1999

on behalf of the
National Association of Professional Insurance Agents

Chairman Leach and members of the Committee, my name is David O. Creighton, Sr. I am president of the Bryton companies, a financial services company that includes an insurance agency in West Des Moines, Iowa. I am also a national board member of the National Association of Professional Insurance Agents ("PIA") and president of their services corporation. PIA is a national trade association representing the interests of over 180,000 independent agents, brokers and their employees licensed by the States to sell insurance throughout the country.

I am pleased to have the opportunity to address you today about H.R. 10 and the important issues surrounding comprehensive financial services reform. I appreciate the opportunity to address the Committee about this matter and congratulate Chairman Leach from my home state of Iowa and Ranking member LaFalce for holding this public hearing.

H.R. 10 as embodied in the Committee print will dramatically reshape the financial services industry and, of particular interest to us, the ability of states to regulate insurance sales activity. The Committee is considering H.R. 10 in an era in which the Office of the Comptroller of the Currency ("OCC") is threatening to preempt state insurance regulation applied to national banks engaged in insurance sales. This is so even though many States already have enacted or are actively considering legislation or regulation designed to protect consumers and level the playing field in this arena. H.R. 10 should endeveor to reconcile this threat to legitimate state insurance regulation. Otherwise, financial services reform could dramatically threaten the traditional system of state regulation of insurance that has been a mainstay in this nation since the infancy of the insurance industry. Simply put, this Committee must protect the system of insurance regulation that has served the country for the last two centuries to ensure consumers remain adequately protected.

This statement is divided into five parts. In Part I, the importance of functional regulation is discussed. In Part II, the basis for the reversal of the PIA's historic opposition to any federal legislation affecting insurance regulation is discussed. Part III addresses the development of the version of H.R. 10 that this Committee currently is considering. Finally, PIA's view of the strengths and weaknesses of the insurance sales provisions included in the 1999 draft of H.R. 10 are discussed in Parts IV and V.

I. THE IMPORTANCE OF FUNCTIONAL REGULATION

At the heart of the current debate about bank involvement in insurance activities is the question of "functional regulation." It seems that everyone endorses such regulation, but views its meaning differently. PIA certainly supports functional regulation, by which we mean that States have the authority to regulate the insurance sales activities of everyone engaged in the activity -- including banks, regardless of the source of their charter, and other so-called "financial institutions."

Such state regulation of bank insurance sales is essential to ensure the integrity of the insurance delivery system and the protection of the insurance-buying public. As the Supreme Court stated half a century ago, "perhaps no modern commercial enterprise directly affects so many persons in all walks of life as does the insurance business. Insurance touches the home, the family, and the occupation or the business of almost every person in the United States."[1] In addition to protecting a large part of the country's wealth, insurance is the essential means by which the "disaster to an individual is shared by many, the disaster to a community shared by other communities; great catastrophes are thereby lessened, and, it may be, repaired."[2] It is thus not surprising that lawmaking bodies have recognized that the business of insurance affects the public welfare such a fundamental way so as to require governmental regulation. Over one hundred years ago, States began creating their comprehensive bodies of law to regulate every aspect of the business -- companies, policies and rates, and sales.

Put simply, there is no alternative to state regulation. There is no federal insurance regulator, and there is no will among federal legislators to create such a federal structure. Federal banking regulators have neither the expertise nor the resources to duplicate the comprehensive insurance regulation that has developed in the States over the last century or so. And, even if they did, it would make little sense, from a policy standpoint, to have such a dual regulatory scheme. In addition, the NAIC identifies problems and exchanges information nationwide.

We fully understand that national banks would prefer to be subject to only one regulator -- and that the regulator of choice for them is the OCC. It is thus not surprising that some national banks have asserted that the OCC alone can regulate all their activities, including insurance sales. We too are often frustrated by a 50-State system of insurance regulation, where we face inconsistencies and variations every day. But this is the regulatory environment everyone else faces, and which national banks must accept if they want to enter the field. It is, on balance, a small price to pay.

II. THE CURRENT NEED FOR CLARIFICATION.

Prior to the mid-1980's, there was never any question that States had the authority to regulate national banks' insurance sales activities. It never occurred to anyone that an agency or agent was free from state regulation simply because the agency was affiliated with a national bank or the agent was employed by such an entity. All that changed when the OCC opined, for the first time, that States cannot apply their anti-affiliation laws, designed to separate banking and insurance, to small-town national banks seeking to exercise their authority under Section 92 (12 U.S.C. § 92) to sell insurance.

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[1] United States v. South-Eastern Underwriters Ass'n, 322 U.S. 533, 540 (1944).
[2] Id. at 412.

As the members of this Committee are well aware, after years of litigation, the U.S. Supreme Court eventually upheld that view, concluding in the *Barnett* case that the McCarran-Ferguson Act does not protect state anti-affiliation laws from preemption by Section 92. The Court thus held that States cannot prohibit national banks from exercising their Section 92 authority.[3] Contrary to what you may have heard, PIA and other agent groups agree with this outcome. We no longer question the rights of banks to sell insurance so long as they do so under the same rules and regulations that we face.

Unfortunately, the Supreme Court's decision left this issue unresolved by not clarifying the extent to which States may regulate the insurance sales activities of national banks. And it is this issue that has become the most troublesome one -- threatening the very fabric of state insurance regulation.

The high Court made it fairly clear that Section 92 authorizes the OCC (the federal agency charged with regulating national banks) to regulate national banks' insurance sales activities and therefore the OCC could issue regulations governing that activity (although it has not chosen to do so to date). If the OCC were to issue regulations governing bank insurance sales, questions would arise whether the OCC's regulations displace state insurance regulation as applied to national banks -- and the extent of that displacement. This is an unacceptable result in our view.

However, the Court stated in dicta (that is, not in an actual part of its ruling but in peripheral discussion) that States can regulate national banks so long as they do not "prevent or significantly interfere with" the banks' ability to exercise their federally authorized powers, such as the power to sell insurance. The banking industry and the OCC, however, have read the *Barnett* decision to impose limitations on States' regulatory authority that extends beyond the "prevent or restrict" standard. They have argued, for example, that the *Barnett* decision stands for the proposition that States cannot "discriminate" against national banks -- whatever such "discrimination" means. And they have argued that States cannot in any way "restrict" or "impair" national banks' insurance sales activities. Only three court decisions have applied the *Barnett* decision, and all three relied upon the "prevent or significantly interfere" standard. Nevertheless, significant uncertainty remains concerning exactly what the decision means regarding the power of States to regulate bank sales activities.

This uncertainty has a very real, and very negative impact, on state insurance regulation. In the wake of the *Barnett* decision and banks' increased involvement in insurance sales, many state legislatures and insurance regulators saw the need to enact laws and regulations that were particularly aimed at banks' activities. Roughly twenty-four States enacted some form of regulation relating to

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[3] *Barnett Banks of Marion Co., N.A. v. Nelson*, 116 S. Ct. 1103 (1996).

banks' activities.[4] Some merely addressed the potential confusion of bank customers regarding the FDIC-insured nature of insurance products sold by banks; and required banks to make appropriate disclosures. Some States saw the need to address the potential coercive effect of bank sales of insurance and required banks to separate their insurance sales and banking activities and to make "choice of agent" disclosures. Still others addressed the potential misuse of confidential customer information by banks without the customers' knowledge and consent. Many of these state consumer protection laws were negotiated and agreed to by banking and insurance agent representatives in the States. Others were not.

The banking industry in general loudly complained that many of these consumer protection laws violated the *Barnett* standard because they "discriminated" against banks and would "significantly interfere" with their ability to

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[4]Seventeen States have enacted statutes and an additional seven regulations in response to *Barnett*. In addition, many other States that historically have permitted bank sales of insurance products, such as Tennessee and Virginia, have maintained special provisions governing bank sales of insurance products for years if not decades. The States that have enacted statutes in response to *Barnett* are: Arkansas (House Bill 2070 (1997)); Colorado (House Bill 97-1175 (Colorado Rev. Stat. §§ 10-2-601 et seq.)); Connecticut (Public Act No. 97-317 (Connecticut Gen. Stat. § 36a-775)); Illinois (House Bill 586 (1997) (The Illinois Insurance Code Article XLIV)); Indiana (House Enrolled Act No. 1241 (1997) (Indiana Code §§ 27-1-15.5-8 et seq.)); Kentucky (Kentucky Laws Ch. 312 (H.B. 429) (1998) (Ky. Rev. Stat. § 304)); Louisiana (House Bill No. 2509 (1997) (La. Rev. Stat. 22:3051 - 3065)); Maine (S.P. 439 - L.D. 1385 ((9-A Maine Rev. Stat. Ann. §§ 4-401 et seq.)); Massachusetts (Senate 1948, Bill No. MA97RSB (May 15, 1998)); Michigan (House Bill No. 5281 (1993) (Mich. Compiled Laws § 500.1243)); New Hampshire (House Bill 799 (1997) (N.H. Rev. Stat. Ann. §§ 406-C et seq.)); New Mexico (House Bill 238 (43rd Legislature, 1st Sess.) (New Mexico Stat. Ann. §§ 59A-12-10 et seq.)); New York (Bill No. 5717-B (July 18, 1997) (New York Banking Law § 14-g; New York Insurance Law §§ 2123 and 2502) (sunsets July 18, 2000)); Pennsylvania (House Bill 1055 amending the Act of May 17, 1921 (P.L. 789, No. 285), Printer's No. 1985 (June 9, 1997), 40 Penn. Stat.); Rhode Island (R.I. Gen. Laws §§ 27-58-1 et seq. Texas (House Bill No. 3391 (1997) (Texas Insurance Code Article 21)); and West Virginia (H.B. 2198 (March 14, 1997) (W.V. Code Chapter 33)). The States that have enacted regulations are: Florida (Dept. of Insurance Rules 4-224.001 - 4-224.014); Georgia (Rules and Regulations of the Office of the Commissioner of Insurance Chapter 120-2-76 (adopted February 17, 1997)); Maryland (Advisory Letter Issued by the Insurance Commissioner and the Commissioner of Financial Regulation on October 31, 1996); Mississippi (Executive Memorandum issued by the Commissioner of Banking and Consumer Finance on May 13, 1997); Ohio (Department of Insurance Rule 3901-5-08); Vermont (Insurance Division Bulletin 117 (June 13, 1997)); and Wyoming (Chapter 16 of the Rules of the Division of Banking).

do business they way they want to. Some banking interests went so far as to formally request the OCC to issue opinions that the laws are preempted under *Barnett* -- requests on which the OCC has not acted to date. For its part, the OCC has let it be known to state insurance regulators that, while it has no intention of duplicating state insurance law, it will exercise its authority to regulate national banks if it sees fit and will support national banks if States overstep their bounds. And while then-Comptroller Ludwig stated publicly that the Illinois consumer protection law satisfied the *Barnett* standard, the banks have since maintained that the OCC has retreated from that position. Any of these state laws, then, may be in danger of preemption -- under some standard. And if they are preempted as applied to national banks, it is virtually certain state legislatures will nullify the laws as applied to state-chartered banks. Indeed, so-called wild card statutes may cause this to happen automatically. This result is unacceptable to PIA.

Our objective in the both the House and Senate has been to resolve this looming uncertainty. And in doing so, avoid potential lengthy litigation, eliminate the possibility that the OCC will displace state regulation of bank insurance sales activities, and generally to preserve the States' ability to regulate in this area. Without legislation that addresses these issues, we face a world of increasing encroachment -- if not down right elimination -- of the existing system of state insurance regulation. You can be assured that such is the goal of at least some banks, especially those comfortable with one principal federal regulator, an OCC who has consistently been their advocate in the insurance area.

III. GETTING FROM WHERE WE WERE TO WHERE WE ARE.

H.R. 10 as passed by the House last Congress went a long way toward addressing our principal concerns, although the bill was still far from perfect. Positives in the bill included a licensing provision clearly requiring every entity that engages in the sale of insurance (including banks) to be licensed as required by state law. This is no insignificant clarification, since the OCC, while advising national banks that they should get licensed, has repeatedly maintained that States cannot force national banks to do so. Indeed, one bank has advanced this "voluntary compliance" argument in a lawsuit in Mississippi. The bill also would have more broadly reaffirmed the McCarran-Ferguson Act and expressly stated that the insurance activities of all entities (including banks) shall be functionally regulated by the States. Both of the licensing and functional regulation provisions were made subject to a more general provision meant to address the appropriate preemption standard and create some clarity, particularly in the wake of *Barnett*.

The bill also would have codified the "prevent or significantly interfere" standard of *Barnett*. It stated, in accordance with the Supreme Court's decision, that no State may prevent or significantly interfere with the ability of insured depository institutions and wholesale financial institutions to engage, directly or indirectly or in conjunction with an affiliate, in any insurance sales or solicitation activity authorized by federal law. If enacted, this would have resolved issues regarding what exactly the preemption standard is that applies to States'

regulatory authority over banks although that standard itself is, of course, ambiguous and court battles over the exact parameters of that standard would have ensued.

Last term's House bill also would have codified the OCC's stated opinion that the Illinois consumer protection law satisfies the *Barnett* test. That is, the bill effectively would have created a safe harbor for any state statutes or regulations that are no more restrictive than the Illinois law. Such state insurance consumer protections, aimed at banks' insurance sales activities, could not be preempted. Statutes and regulations falling outside the safe harbor would have been subject to the "prevent or significantly interfere" test without clarification of that test.

The bill also would have created a new court proceeding where, if a state insurance regulator and federal banking regulator disagree as to whether a state insurance sales provision is or is not preempted -- the court would have decided the question on the merits, without unequal deference to either regulator. This "no unequal deference" provision is especially important because banks and the OCC have argued that the OCC's views alone are entitled to consideration under Supreme Court precedent. In such a world, the views of insurance regulators are entitled to no consideration according to the OCC and the banks merely because they are state regulators. PIA has consistently maintained that where there is a clash of state and federal law, and the federal banking regulator has no expertise as to insurance, neither regulator's views should get deference over the views of the other.

While the House version would have been a real improvement over the status quo, many of the benefits of the bill were stripped out when the legislation moved to the Senate. The Senate Banking Committee's objective was to bring more banking support to the bill. With that objective in mind, then Senate Banking Committee Chairman D'Amato directed representatives from the insurance agent community to negotiate with representatives of the banking and insurance underwriting industries as well as the NAIC, to see if movement could be made. Our objective in these discussions, apart from those pursued in the House, was to ensure that no state insurance consumer protection laws would be automatically displaced or preempted by Congress. We successfully rebuffed attempts by banks to create a ceiling on permissible state consumer protection laws that would not cover existing state laws, and to list certain laws that would be preempted (such as controlled business statutes and laws that require physical separation of the insurance and banking activities).

The resulting Senate Banking Committee compromise provides the basis for the version of H.R. 10 before the committee today. This version has many positive attributes, but it also includes a number of pitfalls for true functionally state regulation of all insurance sales. For example, current state laws and regulations would be subject to *Barnett* -- without any clarification as to what the decision means -- with a diminished safe harbor that falls far short of the Illinois requirements. Moreover, in any challenge to the laws that fall outside the

safe harbor, the OCC could argue that it alone was entitled to deference; the "no unequal deference" provision would not apply. As a practical matter, the safe harbor would effectively become a ceiling because States would be prohibited from enacting any laws that treat banks differently from others, or that significantly impact banks worse than others, except as provided in the safe harbor. The *Barnett* standard (again, without clarification) would apply in addition to the "non-discrimination" standard to new laws outside the safe harbor.

This essentially creates a two-pronged test for any new state consumer protection laws. New laws must first pass the undefined *Barnett* "prevent or significantly interfere" test and then a new non-discrimination test that doesn't acknowledge any rational reason that bank insurance sales forces might legitimately be treated differently than others. The one bright spot in H.R. 10 is that the "no unequal deference" standard would apply to any challenge to a state law under this new two-pronged test. As should be evident, the current proposal has its share of positives and negatives which are both discussed in more detail in the final two portions of this testimony.

As we will demonstrate, H.R. 10 as currently drafted would ensure that the business of insurance is, for the most part, functionally regulated at the state level. However, in many important respects, the proposed legislation undermines important attributes of existing state regulatory schemes. And, it does little to resolve some of the most basic uncertainties regarding the permissible scope of state regulation of national bank sales of insurance products that are sure to be the focus of protracted litigation for years to come.

IV. THE ARGUMENT IN SUPPORT OF H.R. 10

The Committee print of H.R. 10 includes several important provisions from last year's bill that PIA supports and believes go a long way toward resolving many of the open issues related to the regulation of bank sales of insurance products. For example, sections 301 - 303 include a positive statement that the insurance sales activities of everyone (including banks) is to be functionally regulated by the States. These sections also reaffirm the McCarran-Ferguson Act requirement that *everyone* engaged in the business of insurance is subject to state regulation of those activities and a requirement that everyone engaged in the sale of insurance products must be properly licensed in accordance with state law. These provisions together should shield against the attacks on state authority that national banks and their regulator currently are in the midst of mounting.

In terms of specific consumer protections, the "safe harbors" included in Section 104(b)(2)(B) list thirteen different categories of regulations that would be protected from preemption. States need not enact precisely the same laws, but so long as they are substantially the same and no more burdensome or restrictive than the provisions set out in the safe harbors, state laws cannot be preempted. These safe harbor provisions would apply to both current and future laws. In addition, Section 307 would establish federal minimum levels of consumer protections that would be applicable in States that have not enacted

bank-specific insurance sales consumer protection laws. The bill would require federal banking regulators to implement the requisite consumer protections which would be applicable wherever the state laws are not as protective of consumer interests.

A "no unequal deference" provision is included in section 306 for preemption challenges to state insurance laws enacted in the future. In short, section 306 enables state insurance commissioners to challenge a federal banking regulator's view that a state law should be preempted and avoid the court giving exclusive deference to the federal banking regulator's view.

V. OVERCOMING H.R. 10's SHORTCOMINGS

As Part IV demonstrates, the current version of H.R. 10 includes provisions designed to preserve functional regulation of insurance. Unfortunately, H.R. 10 as currently written also jeopardizes many of the state consumer protection laws already in place, the sole purpose of which are to protect the very consumers H.R. 10 purports to serve. PIA believes H.R 10's shortcomings can be ameliorated provided the following four changes are included in the legislation. The Committee should: (1) clarify the proper preemption standard; (2) eliminate the "non-discrimination" provision; (3) clarify that state insurance regulators are entitled to receive consideration of their views in court when disputes arise between regulators; and (4) strengthen the safe harbor provisions.

Clarify the Appropriate Preemption Standard.

H.R. 10 must make clear that State laws regulating insurance sales practices may be preempted *only if they actually or constructively prohibit* national banks or bank-affiliated entities from exercising their federally authorized insurance powers. Only by clarifying the *Barnett* standard in this manner will H.R. 10 fully empower States to perform the regulatory duties that Sections 301 - 303 contemplate. Such clarification requires revision of the preemption standard applicable to insurance sales in Section 104(b)(2). This standard is, in our view, the approach dictated by the line of Supreme Court cases that led to the *Barnett* decision. This is the level of "interference" the Supreme Court had in mind when limiting the States' authority, since preemption generally requires an actual conflict between state and federal law.

Eliminate the "Non-Discrimination" Provision.

Section 104(c) prohibits States from distinguishing in any way between financial institutions and other entities -- and from enacting provisions that have a greater effect on financial institutions than on other entities -- in regulating the sale of insurance products. However, as over 25 States and the OCC itself have previously recognized, the sale of insurance products by financial institutions creates unique problems that require consumer protections tailored for the financial institution context. These laws are not "anti-competitive" nor are they driven by a desire to keep banks out of the business. Indeed, they expressly

recognize that banks are in the business to stay. They merely recognize the unique aspects of bank insurance sales operations and attempt to create a level playing field between bank and non-bank insurance agents and brokers, and to protect consumers from potential abuse.

Banks' access to cheap funds, FDIC-insured status, and control over credit, puts them in a position not held by others in the insurance industry. One need only look to federal anti-tying provisions which prevent banks from pairing the extension of credit to the purchase of insurance to understand why state might enact laws that treat banks differently. Many States believe provisions regulating bank sales of insurance are necessary to prevent coercion and confusion and to protect customer privacy.

Indeed, as the OCC itself recognized when it published an advisory letter to provide guidance to national banks on insurance and annuity sales activities,[5] there are many instances in which "discriminatory" regulation (in the sense of treating banks differently than non-banks) is appropriate and necessary. Consequently, there is no basis on which to argue that the type of "discrimination" present in consumer protection provisions such as those contained in the Rhode Island Act are per se illegitimate.[6]

Although the safe harbor provisions in H.R. 10 attempt to capture many of the substantive state regulatory controls currently imposed, they simply do not include the current universe of regulatory requirements designed to address bank-specific consumer protection issues. Furthermore, they cannot possibly take into consideration the wide array of issues that may in the future require bank-specific regulatory solutions. As long as the legislation makes clear that States may not prohibit the exercise of authorized insurance sales powers, there is no need to bar state legislatures and governors from implementing bank-specific solutions designed to address consumer protection concerns.

Clarify That The Opinions of State Insurance Regulators Are Entitled To Consideration In Court Reviews of State Insurance Laws.

Although Section 306 creates a special procedure for court proceedings challenging state insurance regulations and dictates that state insurance regulators and the OCC are entitled to equal consideration during that review, Section 104(b)(2)(C) exempts laws in existence prior to September, 1998 from this "no unequal deference" standard. This exemption places in jeopardy a plethora of existing State regulatory provisions because H.R. 10 implicitly grants the OCC *Chevron* deference when a court confronts the question whether a challenged provision should be preempted because it "interferes" with a national

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[5]See OCC Advisor Letter AL 96-8 (October 8, 1996).
[6]Absolutely nothing in the Barnett decision, or its precedents, supports the argument that a State cannot regulate national banks in a manner that distinguishes them from non-banks.

bank's exercise of its insurance sales powers. This is especially maddening to PIA and the insurance community at large because the OCC simply has no expertise in the regulation of the business of insurance.

Moreover, the OCC has repeatedly demonstrated that the expansion of national bank powers is at the forefront of its concerns. This preoccupation and unmitigated regulatory advocacy has led the OCC to interpret banking law in a suspect manner. For example, the OCC has interpreted a small exception to the general prohibition on national bank sales of insurance which authorizes national banks located and doing business in places with populations not exceeding 5,000 inhabitants to allow national bank agents to sell insurance from anywhere to anyone so long as they are headquartered in a small-town bank office. For these reasons, PIA believes that OCC interference with State regulation of the business of insurance -- and exclusive consideration by the Courts of OCC opinions regarding such regulation -- is inappropriate. The Courts are well qualified to determine whether State regulations prevent or significantly interfere with a national bank's exercise of its insurance sales authority. Requiring or implying that the OCC is entitled to special deference over and above that accorded state insurance regulators on such questions is therefore unacceptable.

Strengthen The Safe Harbor Provisions.

Finally, PIA believes that the current list of safe harbors included in H.R. 10 must be strengthened and at a minimum encompass the full range of safeguards included in the Illinois legislation. Consumer protection provisions are the essence of regulation of banks insurance sales in many states. Unfortunately, a number of legitimate state consumer protection laws --requiring separation of banking and insurance personnel and activities, for example -- have been excluded from the list of consumer protections included in H.R. 10's safe harbors and will not be protected from OCC and bank challenges. Such exclusion jeopardizes other legitimate state consumer protection laws and may undermine the regulatory scheme of many States. Many such laws have been designed to address the unique issues that arise when banks -- in their unique position of controlling federally insured credit capital -- also engage in the business of insurance. A risk of including a limited list of safe harbors in H.R. 10 is that it may end up as a ceiling for legitimate state consumer protection laws rather than a floor as intended.

CONCLUSION

PIA no longer opposes federal efforts to permit affiliation between banks and the insurance industry. In fact, PIA and its members now embrace the prospect of viable financial services reform legislation. The world is changing and the laws that govern that world must evolve in an effort to respond to consumer needs. There is perhaps no area in which the need for such new laws is more acute than in the financial services context. Any such legislation, however, must create a world in which all pertinent regulatory concerns are addressed lest the

consumers -- the citizens for whose interests any such legislation must be designed to address -- will suffer. For insurance this means that a level playing field must exist for all those who sell and buy insurance. For PIA this means functional state regulation by the very state insurance departments who have been charged with that task for almost two centuries for all those who sell insurance whether they do so from a professional insurance agent's office, a bank lobby, or elsewhere.

PIA thanks this Committee and in particular Chairman Leach and Ranking member LaFalce for permitting us to offer our views. We look forward to working further with you on financial services reform legislation.

Testimony before the Committee on Banking and Financial Services

U.S. House of Representatives
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on H.R. 10
Financial Services Act of 1999

Presented by
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NAMIC

My name is Neal Menefee, President and CEO of Rockingham Mutual Insurance Company, and I am testifying today as Chairman of the Legislative Steering Committee of the National Association of Mutual Insurance Companies (NAMIC). NAMIC represents more than 1,200 property/casualty insurance companies, the vast majority of them are organized in the mutual form.

NAMIC's membership ranges from the largest to the smallest insurance companies in the United States, but most are regional and small companies. Our members generally underwrite all types of property/casualty insurance, including homeowners, auto, farm owners, commercial, and specialty lines. They are located throughout the country. As a group, these companies may be the most negatively affected by the outdated laws that govern the financial services sector.

The marketplace is evolving at a rapid pace and consumers have come to expect their financial services partners to be able to provide one-stop-shopping for a variety of product and services. On the face of it, you might think that NAMIC member companies would be well positioned to face this challenge as more than half have a tradition of service to their policyholders and agents that goes back more than one hundred years. But there is a major obstacle in their way: unfair competition created by outdated federal laws that are interpreted in the national banks' favor by a Comptroller who receives undue deference from federal courts.

The most important message that I can deliver to you today is that the current state of laws governing the financial services industry is unacceptable. Insurance companies cannot effectively compete and serve the needs of current and potential customers unless

federal laws are changed – and soon. The aggressive activities of ultra-large corporations like Citigroup, the new entity combining Citicorp and Travelers, is resulting in great leverage causing the OCC to continue to issue rulings extending the reach of banks into the insurance arena. The multi-billion dollar, multi-national corporations like Citigroup are simply using this new latitude provided by OCC to respond to the same changing customer preferences I mentioned earlier. But the company I manage cannot affiliate with a commercial bank situated in the Shenandoah Valley of Virginia a short distance from our offices. Even if there were a possibility of approval, we couldn't afford the legal and regulatory gymnastics necessary to get there under current law.

Of course, for years the law not only prohibited affiliations between banks and insurance companies, it also prohibited banks from engaging in insurance activities. That is no longer the case. National banks enjoy a Comptroller who has aggressively interpreted those laws to allow banks to engage in insurance activities, mainly sales. Recent actions by the Comptroller indicate that approval of insurance underwriting is around the corner. Lest you think insurance companies are unduly paranoid about the intentions of banks and their federal regulators...talk to our colleagues in the securities industry.

H.R. 10 is a welcome solution to these problems. The bill removes legal barriers enacted in the 1930's and 1950's that no longer serve consumers or financial markets. It recognizes the evolution of the marketplace by creating a framework to allow the insurance, banking, and securities industries - companies large and small - to move forward into the next century on an equal basis.

I would like to focus my testimony on two aspects of H.R. 10 - the expedited and equalized dispute resolution mechanism in section 306, and the mutual redomestication provisions found in subtitle B of Title III. Both provisions are important to NAMIC members, and I am proud to say that NAMIC was instrumental in conceiving of and promoting the dispute resolution mechanism, a linchpin of H.R. 10.

First, some history. Faced with repeated Comptroller-led forays into their business by banks, insurance agents sought relief from the courts in the 1980's and 90's. Relief was not to be found. The courts consistently ruled in the OCC's favor, invoking the Chevron doctrine which states that if a statute is silent or ambiguous with respect to a specific issue, the court should defer to a reasonable interpretation of the statute by the agency that has the duty to administer it. Such was the opinion reached in Chevron U.S.A. Inc. v. Natural Resource Defense Council, 467 U.S. 837 (1984). When courts invoke Chevron, it is nearly impossible to dispute the Comptroller's determination as to what insurance activities are part of or incidental to the business of banking, giving them free reign to expand banks' insurance activities. The dispute resolution provision in section 306 is intended to address this problem.

Section 306 allows conflicts between state insurance regulators and federal banking regulators about the definition of banking and insurance products and the extent of preemption of state insurance laws or regulations to be litigated expeditiously and without "unequal deference" to either regulator. In other (and fewer) words, section 306

instructs courts to promptly review cases and rule on the merits, not the territorial interests of a particular regulator.

This section distressed the OCC greatly last year and they may continue to oppose it. You should not be moved by their pleas. Because H.R. 10 contains language in sections 104 and 304 intended to be unambiguously clear with respect to which insurance activities can be done by banks and the extent to which they will be subject to state laws, a court should no longer have any need to invoke Chevron when interpreting the statute, regardless of section 306. Section 304 is extremely important in order to maintain an explicit definition of insurance. But most importantly, because the questions subject to the dispute resolution mechanism involve conflicts between federal and state regulators over the definition and conduct of insurance products and activities and because the McCarran-Ferguson Act leaves the states as the primary regulators of insurance, it is reasonable and fair to require courts to show equal deference to a state insurance regulator and a federal banking regulator. The need for an expedited and fair dispute resolution is obvious and retaining Section 306 is critical to our support of H.R. 10.

As you know, capital is the lifeblood of a financial services organization. In the case of mutual companies, however, options for raising additional capital are somewhat limited. That is why NAMIC members also support strongly the sections of the bill that address redomestication of mutual insurers. About 21 states have passed laws permitting their mutual insurance companies to convert into a mutual holding company structure. These transactions involve the conversion of the mutual insurance company into a stock

insurance company, which is then controlled by a mutual holding company directly, or indirectly through a stock holding company. The members of the former insurance company become members of the holding company. You are no doubt familiar with these conversions, since their prototype is the thrift holding company.

To take advantage of the new affiliations and powers granted by H.R. 10, an entity must be in a holding company structure. However, as noted above, not all states have passed the legislation necessary to allow mutuals to establish holding companies. This means that even with H.R. 10 mutual companies could be at a significant competitive disadvantage. Subtitle B of Title III permits a mutual insurer located in a state that has not yet approved mutual holding company legislation to transfer its domicile to a state that has. In order to use the federal redomestication provision, the mutual's plan of reorganization must meet specified procedural and substantive requirements. The requirements include: approval by at least a majority of the board and policyholders, continued control of the holding company by the former mutual's policyholders, a prohibition against awarding stock grants or options to directors and officers of the holding company and the converted insurer for at least 6 months after completion of the initial public offering, preservation of policyholders' contractual rights, and a finding by the insurance regulator of the transferee domicile that the transaction is fair and equitable. State laws of any transferor domicile that conflict with the transfer are preempted. The section also prohibits the application of state laws that would treat a redomesticated insurer differently than any other insurer operating in that state.

Some have argued that it is inconsistent for the insurance industry to both support the redomestication provisions of H.R. 10, and insist on maintaining state regulation of insurance. We disagree. NAMIC members were initially drawn into discussions about, and advocacy for, financial services modernization in order to defend their customers and companies from banks engaging in the insurance business under a different set of rules. The Comptroller allowed banks to engage in insurance activities subject to national banking laws, instead of the state insurance laws that govern the conduct of our companies. We do not think any reasonable person will disagree that when it comes to insurance, state insurance laws provide far more consumer protections than do national banking laws. In addition, states have years of experience in safety and soundness and rate regulation of insurance companies. It only makes sense that banks engaging in permissible insurance activities directly, in the case of sales, or indirectly, in the case of underwriting, should do so subject to state insurance laws. That is the principle of functional regulation and it will work.

But since H.R. 10 mandates a holding company structure for these activities and affiliations, Congress must recognize that mutual insurance companies will be disadvantaged if they are located in a state that does not yet permit such holding companies. H.R. 10 does not require states to allow mutual holding companies; nor does it create a federal mutual holding company law. It merely allows insurance companies to move freely and without negative consequences into a state that allows them to create a holding company in order to enjoy the affiliations and powers granted under H.R. 10. We believe the redomestication provisions are forward looking, consistent with

functional regulation, and necessary to fully equalize the implementation of this historic legislation.

There is one provision of H.R. 10 that we do not support - the limited grandfather for commercial activities. Under Title I, a financial holding company that derives at least 85% of its revenues from financial activities may retain, subject to certain conditions, any commercial or "nonfinancial" activities it was engaged in as of September 30, 1997, for a 10-year period only. The Federal Reserve can grant a one-time extension for an additional 5 years. Many insurance companies are affiliated with commercial companies or otherwise engaged in limited commercial activities. State laws and regulations insure that these activities pose no threat to policyholders and we are aware of no evidence that commercial activities create an undue concentration of resources or an anticompetitive effect. We urge you to consider allowing insurance companies to retain their existing commercial affiliations.

On balance, H.R. 10 represents a good compromise and an excellent place to begin the process of modernizing the nation's financial services laws. Though debates on financial services are often characterized as one segment of the industry versus another, it is important to recognize that with H.R. 10, the real winners at the end of the legislative process will be the American people. Financial modernization will enable consumers to access the entire range of financial products and services through whatever trusted source that they choose: a commercial bank, securities firm, life insurance company or their mutual property/casualty insurer. At the same time, these service providers will be free

to compete vigorously – to the benefit of the consumer – with no individual segment enjoying an unfair advantage over any other. By allowing financial services companies to compete equally in a regulatory structure that preserves safety and soundness, H.R. 10 will allow NAMIC members and their fellow insurance companies to better meet the current and future needs of consumers.

Our companies have worked hard to get ready for the 21st century. By modernizing our financial services laws you will be providing for a new era of competition and service to customers in the new millennium.

STATEMENT OF THE ALLIANCE OF AMERICAN INSURERS

This statement is submitted on behalf of the members of the Alliance of American Insurers (Alliance) to the Subcommittee on Financial Institutions and Consumer Credit Subcommittee, House Banking Committee, regarding the Financial Services Act of 1999 (H.R. 10). The Alliance is a national trade association representing more than 270 property and casualty insurance companies. Alliance membership is diverse, including major multi-line writers doing business in every state, as well as regional writers and niche companies. Alliance members offer a broad range of personal and commercial insurance products.

We believe the legislation before this committee is a fair and balanced approach to financial services modernization reform. H.R. 10 is important to insurers as well as all the other stakeholders in the new financial services marketplace. We are at a critical juncture in the 106th Congress. The Alliance believes that the future of U.S. financial markets will be forever changed and shaped by the forces of convergence, consolidation, technology and globalization. It is crucial that Congress address these issues and the direction of changes rather than have to come in at a later date to address problems that result from a lack of Congressional direction.

The Alliance supports the present version of H.R. 10, and would like to highlight several important areas that we believe must be considered in any final financial services legislation.

Structural framework

H.R. 10 provides a structural framework for financial services modernization that gives all providers of financial services equal opportunity - Insurers, banks and securities firms can affiliate, if they so choose. It is important that structure not create imbalance.

Debate has centered over whether affiliation between the industries should be in a separate bank holding company or in an operational subsidiary. Treasury has argued that H.R. 10 is deficient in that it does not authorize national banks to own operating subsidiaries, which are subsidiaries of the bank that engage in activities that they are forbidden by Federal law to conduct directly. On the other hand, the Federal Reserve Board believes that this structure creates profound adverse effects for the Federal safety net. We believe that it is not wise and will have negative ramifications on insurers if Congress expands the ability of banks to engage in new principal activities through operating subsidiaries. Specifically the advantages of this approach are cheaper funding than is available to other competitors because of access to federally backed deposit insurance, access to the discount window and access to the Fed's payment system. This in effect allows the bank to have a lower cost of capital and because of

capital "stacking" a greater leverage than other companies. There is no question that this creates an advantage for one type of provider over another. This is not the operation of the market, this is regulation conferring an advantage. This is bad public policy.

We believe significant conflicts with state insurance laws may occur if national banks are permitted to own operating subsidiaries engaged in insurance underwriting activities. This would happen because the insurance company would be viewed as a subsidiary of an FDIC insured national bank; therefore, state insurance laws pertaining to the insurance subsidiary would be subordinated to the ultimate goal of the Federally regulated parent bank in maintaining the solvency of the bank.

The Alliance believes that operating subsidiaries conflicts with the ultimate safety and soundness of banking regulation. Federal law provides that the Comptroller of the Currency's primary function is to ensure the solvency of national banks. Therefore, the financial solvency of an operating subsidiary would affect the parent bank. The OCC would by federal law be required to protect the solvency of the parent bank, even if those actions would conflict with state insurance laws, or go against the wishes of state insurance regulators. We do not believe that functional regulation can be effective if banks are allowed to own operating subsidiaries engaged in insurance underwriting activities.

We encourage the Banking Committee to follow the arguments advanced by the Federal Reserve Board and allow affiliation only in a separate bank holding company. There is no rational argument for banks big or small to operate insurance activities inside the bank.

Preserves state regulation of insurance

The Alliance advocates a system of functional regulation, whereby insurance activities continue to be regulated at the state level by regulators with expertise in the field, and banking and securities activities continue to be regulated by the appropriate regulator, at either the state or federal level. Regulation should be neutral to all competitors in the marketplace. In order to accomplish this goal, legislation must contain a strong definition of insurance, along with an important dispute resolution process to handle any disagreements between the states and the OCC regarding whether a new product, or variation of an existing product, is insurance or banking.

The OCC has asserted itself far beyond its jurisdiction and expertise. While we do not believe the *Barnett Bank v. Nelson*, 116 Sup. Ct. 1103 case establishes an unreasonable standard, we strongly believe that the OCC is stretching *Barnett* far beyond its reasonable bounds. The *Barnett* court made it clear that states are not deprived of the power to regulate national banks where doing so "does not prevent or significantly interfere with the national bank's exercise of its powers." 116 Sup. Ct. at 1009. The *Barnett* standard recognized the historical role of insurance regulation, both federal and state.

Without an adequate definition of insurance new products will be deemed "closely related to banking" and not subject to financial regulation, or consumer protection of state insurance departments. The OCC knows little about insurance risk because that is not the expertise of a banking regulator. The insurance business is vastly different than the banking business and requires different regulatory skills.

H.R. 10 contains both the strong definition of insurance and a streamlined equal deference provision. We encourage the Committee to preserve functional regulation of insurance by retaining these provisions.

Conclusion

Functional regulation is a central principle of H.R. 10. We believe the legislation attempts to direct the market in a way that assures equal regulation and equal competitive opportunity among financial service providers, as well as adequate consumer protections for consumers. With an increasingly global financial market, such an approach is critical to the international competitiveness of U.S. financial service providers. We also believe that H.R. 10 establishes Congress's role in providing the framework and guidance for the market.

We are hopeful that 1999 will be the year of meaningful financial services reform.

The Alliance expresses appreciation to Chairman Leach for his leadership on this issue. We look forward to working with the committee.

STATEMENT
OF THE
NATIONAL ASSOCIATION OF INDEPENDENT INSURERS
ON
H.R. 10
FINANCIAL SERVICES ACT OF 1999
BEFORE THE
COMMITTEE ON BANKING AND FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES
FEBRUARY 10, 1999

The National Association of Independent Insurers (NAII), a property/casualty trade association representing more than 600 companies, supports H.R.10, the "Financial Services Act of 1999." We agree that modernization of our financial services system is long overdue and we commend Chairman Leach for scheduling early consideration of this legislation.

Under the McCarran-Ferguson Act of 1945 (15 USC Sec. 1011-1015), the states were granted the authority to regulate the business of insurance. Despite various attempts to rescind or modify this authority in recent years, Congress has chosen to preserve the regulation of insurance activities at the state level. The prevailing competitive climate in the industry again demonstrates the wisdom established over 50 years ago with passage of the McCarran-Ferguson Act. NAII and its members continue to believe that state regulation of insurance is far more effective and produces greater efficiencies within the marketplace than the intervention of federal regulation.

Recognizing the importance of this concept, NAII opposed financial services modernization legislation early in the 105th Congress because it infringed upon state insurance regulation by pre-empting state laws or imposing federal mandates upon state insurance regulation. Eventually, we supported the legislation after changes were adopted that diminished the federal intrusion into state insurance regulation mandated in the bill by providing greater assurances to state regulators that they would regulate bank insurance activities. This is known as "functional regulation." As we know, Congress failed to pass H.R. 10 last year despite the tenacious efforts of Chairman Leach and other leaders on the House Banking Committee.

This year's version of H.R.10 provides for the "functional regulation" of financial activities, thus ensuring that all new entrants into the insurance business will be subject to the same regulatory standards as existing insurance companies. NAII commends Chairman Leach for introducing the bill with this concept preserved. In addition, there are several other components important to NAII and its members contained in H.R. 10. These include provisions requiring insurance underwriting to be conducted through a separate corporate structure thus preserving the separation of insurance and banking functions; defining insurance as those products so regulated by the relevant state insurance regulator as of January 1, 1997; creating a procedure for resolving disputes "without unequal deference" in the U.S. District Court of jurisdiction over

products falling under the insurance definition; providing thirteen safe harbors to protect state insurance regulation within the bounds of the *Barnett Bank* decision; and providing appropriate consumer protections. All of these elements are essential elements in a final proposal for NAII's continued support of financial services modernization.

However, NAII believes that language currently in the bill may upset the delicate balance which the concept of "functional regulation" seeks to achieve.

We believe that the language in Sec. 104(b)(4)(D)(ii) and Sec. 104 (c)(2) may unintentionally establish a loophole through which a bank could avoid state insurance regulation of activities other than sales of insurance. These provisions, as currently drafted, would permit a state insurance regulation to be deemed discriminatory as a matter of law and thus subject to preemption by federal law, even if the regulation was completely neutral in its application and the state regulator had no intention whatsoever of discriminating against banks.

NAII and its members do not believe it was the intention, under the carefully balanced doctrine of "functional regulation" established and solidified by H.R. 10, to permit banks to avoid state insurance regulation of activities where the state regulator had no intention of discriminating against banks. NAII agrees with and supports the proposition that state insurance regulation should be the same for both insurance companies and bank insurance affiliates.

Accordingly, NAII recommends that subsection (b)(4)(D)(ii) be amended by simply adding a sentence at the end of the section as follows:

> "However, this subsection (ii) shall not apply where such impact was not intended by the state and such state action has a legitimate, nondiscriminatory basis."

We also recommend that subsection (c)(2) be amended by adding a similar sentence at the end of the section as follows:

> "However, this subsection (2) shall not apply where such impact was not intended by the state and such state action has a legitimate, nondiscriminatory basis."

NAII submits this language as being consistent with cases under the Civil Rights Act of 1991: *International Brotherhood of Teamsters v. United States 431 U.S. 324, 52 L.Ed. 2d 396, 97 S. Ct. 1843 (1977); Wards Cove Packing Co. v. Atonio, 490 U.S. 642, 104 L. Ed. 2d 733, 109 S. Ct. 2115 (1989), McConico v. Cincinnati Gas & Electric Co., 1997 U.S. App. LEXIS 10786.* In these cases, language permitting rebuttal of the adverse impact claim included "job-related," "consistent with business necessity," and "by articulating a legitimate, nondiscriminatory business reason for acting as it did."

NAII also believes the thrift charter concept should be protected in a final version of financial services modernization legislation. The unitary thrift charter provides a means for insurers to enter the broader financial services market. A number of property/casualty insurance companies have either applied for, or are in the process of applying for, thrift charters. Accordingly, we

believe Title IV of the bill , 'Unitary Savings and Loan Holding Companies,' should be eliminated or amended to properly reflect the current status of these applications.

In sum, NAII and its members have long been champions of free markets and the free enterprise system. Therefore, NAII and those affiliated with the Association are not troubled by the notion of greater competition as banks enter the business of insurance. In fact, many property/casualty insurers are looking at banks as potential business partners that will create new cross-marketing opportunities. Increased competition in insurance markets means consumers will have a greater selection of service providers and the lowest possible prices.

We are apprehensive, however, about regulatory reform of the banking industry if the new regulatory environment permits banks transacting insurance to be governed by special rules or by bank regulators. Insurers, which must operate under state insurance laws and receive oversight from state insurance regulators, will be at a tremendous disadvantage. NAII firmly believes that a restructured bank regulatory system must address this issue in order to avoid unfair competition that could distort or dislocate insurance markets. Preserving "functional regulation" in a final version of H.R. 10 will achieve the goals desired by NAII and its members.

We stand ready to work with Chairman Leach and each member of the House Banking Committee toward this end.

APPENDIX

February 11, 1999

Statement by

Alan Greenspan

Chairman

Board of Governors of the Federal Reserve System

before the

Committee on Banking and Financial Services

House of Representatives

February 11, 1999

It is a pleasure to appear before the Committee to present the views of the Federal Reserve on the need to enact legislation to modernize the U.S. financial system. The Federal Reserve continues to support strongly the enactment of such legislation and believes that H.R. 10 contains the fundamental principles that should be included in such legislation. I commend the Committee for taking up this vital matter so promptly.

The Need for Financial Reform

U.S. financial institutions are today among the most innovative and efficient providers of financial services in the world. They compete, however, in a marketplace that is undergoing major and fundamental change driven by a revolution in technology, by dramatic innovations in the capital markets, and by the globalization of the financial markets and the financial services industry.

For these reasons, we support, as we have for many years, major revisions, such as those included in H.R. 10, to the Glass-Steagall Act and the Bank Holding Company Act to remove the legislative barriers against the integration of banking, insurance and securities activities. There is virtual unanimity among all concerned--private and public alike--that these barriers should be removed. The technologically driven proliferation of new financial products that enable risk unbundling have been increasingly combining the

characteristics of banking, insurance, and securities products into single financial instruments. These changes, which are occurring all over the world, have also dramatically altered the way financial services providers operate and the way they deliver their products.

In the United States, our financial institutions have been required to take elaborate steps to develop and deliver new financial products and services in a manner that is consistent with our outdated laws. The costs of these efforts are becoming increasingly burdensome and serve no useful public purpose. Unless soon repealed, the archaic statutory barriers to efficiency could undermine the global dominance of American finance, as well as the continued competitiveness of our financial institutions and their ability to innovate and to provide the best and broadest possible services to U.S. consumers.

We believe that it is important that the rules for our financial services industry be set by the Congress rather than, as too often has been the case, by banking regulators dealing with our outdated laws. Only Congress has the ability to fashion rules that are comprehensive and equitable to all participants and that guard the public interest.

The market will continue to force change whether or not Congress acts. Without Congressional action, changes will occur through exploitation of

loopholes and marginal interpretations of the law that courts feel obliged to sanction. This type of response to market forces leads to inefficiencies and inconsistencies, expansion of the federal safety net, potentially increased risk exposure to the federal deposit insurance funds, and a system that will undermine the competitiveness and innovative edge of major segments of our financial services industry. Delay in acting on financial modernization legislation limits Congress's options as these developments proliferate and complicate, increases the difficulty of enacting the safeguards included in H.R. 10 to protect safety and soundness and the public interest, and denies to consumers the benefits that immediate changes in our outdated banking laws will surely bring.

H.R. 10 also recognizes another dimension of the changing nature of banking and financial markets: that financial modernization means more than authorizing new powers and affiliations. Not only are we experiencing a revolution in financial products and their delivery, the U.S. is also at a historic crossroads in financial services *regulation*. It is becoming increasingly evident that the dramatic advances in computer and telecommunications technologies of the past decade have so significantly altered the structure of domestic, indeed, global finance as to render our existing modes of supervision and regulation of financial institutions increasingly obsolescent.

The volume, sophistication, and rapidity of financial dealings will inevitably lead to supervisory emphasis on oversight of risk management of financial institutions and a marked scaling back of outmoded loan file and balance sheet surveillance. As we move into the twenty-first century, the remnants of nineteenth century bank examination philosophies will fall by the wayside. Banks, of course, will still need to be supervised and regulated, in no small part because they are subject to the safety net. My point is, however, that the nature and extent of that effort needs to become more consistent with market realities. Moreover, affiliation with banks need not--indeed, should not--create bank-like regulation of affiliates of banks.

This shift in supervisory mode, which is already underway, is market driven. It is not the result of some potentially reversible ideology. Such an approach is captured in H.R. 10 in many of the so-called "Fed-light" provisions, and we at the Fed strongly support this approach.

H.R. 10 also, in our judgment, has chosen the appropriate structure to combine banking, securities and insurance firms using financial service holding companies. While we enthusiastically support the new powers granted to financial service holding companies, we just as strongly believe that they should be financed by the marketplace, not by instruments backed by the sovereign

credit of the United States. The requirement that the new powers be conducted through holding company affiliates minimizes the expansion of the use of the subsidies arising from a safety net backed by the U.S. taxpayer and serves to promote the safety and soundness and stability of our banking and financial system.

The rejection of expanded powers for subsidiaries of commercial banks, at least those conducted as principal, is a decision that will inhibit the widespread employment of federal subsidies over a wide range of activities. These activities, if conducted in bank subsidiaries, would accord banking organizations an unfair competitive advantage over comparable insurance and securities firms operating independently or as bank holding company subsidiaries.

Even more important, to inject the substantial new subsidies that would accrue to operating subsidiaries of banks into the currently mushrooming domestic and international financial system could distort capital markets and the efficient allocation of both financial and real resources that has been so central to America's current prosperity. The choice of requiring the new powers to be harbored in affiliates of holding companies, not in the so-called op-subs of their banks, will significantly fashion the underlying structure of twenty-first century finance.

Another twenty-first century issue is whether we should move beyond affiliations among financial service providers and allow the full integration of banking and commerce. As technology increasingly blurs the distinction among various financial products, it is already beginning to blur the distinctions between predominately commercial and banking firms. We cannot rule out whether sometime in our future full integration may occur, potentially with increased efficiencies. But how the underlying subsidies of deposit insurance, discount window access, and guaranteed final settlement through Fedwire, are folded into a commercial firm, should the latter purchase a bank, is crucially important to the systemic stability of our financial system.

It seems to us wise to move first toward the integration of banking, insurance, and securities as envisioned in H.R. 10 and employ the lessons we learn from that important step before we consider whether and under what conditions it would be desirable to move to the second stage of the full integration of commerce and banking. Nothing is lost, in my judgment, by making this a two stage process. Indeed, there is much to be gained. The Asian crisis last year highlighted some of the risks that can arise if relationships between banks and commercial firms are too close, and make caution at this stage prudent in our judgment. In line with these considerations, the Board continues to support

elimination of the unitary thrift loophole, which currently allows any type of commercial firm to control a federally insured depository institution.

These principles, which we see as fundamental to financial modernization, are embodied in H.R. 10. As in all such major legislation, there are, and will be, numerous provisions only indirectly associated with the legislation's core principles that often foster disagreements. These surrounding details are doubtless important, but not so important that they should be allowed to defeat the consensus that has developed around the key principles embodied in H.R. 10. It would be a disservice to the public and the nation if, in the fruitless search for a bill that pleases everyone in every detail, the benefits of this vital consensus are lost or further delayed.

The decision to use the holding company structure, and not the universal bank, as the appropriate structure to allow new securities and insurance affiliations is strongly driven by several key principles embodied in H.R. 10. These principles include that new powers and affiliations should be financed by the market and not by the sovereign credit of the United States, and that supervision of nonbank affiliates must not use the exhaustive bank examination method.

Importantly, that decision also prevents the spread of the safety net that would inevitably lead to a weakening of the competitive strength of large segments of our financial services industry because those securities, insurance and other financial services providers that do not operate as subsidiaries of banks would be at a serious disadvantage to similar firms owned by banks. By fostering a level playing field within the financial services industry, we contribute to full, open and fair competition as we enter the next century.

This choice of the holding company structure is also critical to the way in which the financial services industry will develop because it provides better protection for and promotes the safety and soundness of our banking and financial system without damaging the national or state bank charters or limiting in any way the benefits of financial modernization. The other route toward full powered commercial bank operating subsidiaries and universal banking would, in our judgment, lead to greater risk for the deposit insurance funds and the taxpayer. It is for these reasons that the Federal Reserve, Securities and Exchange Commission, many state functional regulators, and many in the affected industries have supported the holding company framework and have opposed the universal bank approach.

In virtually every other industry, Congress would not be asked to address issues such as these, which are associated with technological and market developments; the market would force the necessary institutional adjustments. Arguably, this difference reflects the painful experience that has taught us that developments in our banking system can have profound effects on the stability of our whole economy, rather than the limited impact we perceive from difficulties in most other industries.

Moreover, as a society we have made the choice to create a safety net for depository institutions, not only to protect the public's deposits, but also to minimize the impact of adverse banking developments on our economy. Although we have clearly been successful in doing so, the safety net has predictably shielded bank shareholders from the full consequences of the risks their banks take. Moreover, since the sovereign credit of the United States fosters the stability of the banking system and guarantees the claims of insured depositors, bank creditors do not apply the same self-interest monitoring of banks to protect their own position as they would without discount window access and deposit insurance. As a consequence, to redress the balance of risk-taking, entities with access to the safety net are required to be supervised and regulated.

In this way, the U.S. government protects its own--that is the taxpayers'--interest, which is the cost of making good on the guarantee.

Put another way, the safety net requires that the government replace with law, regulation, and supervision much of the disciplinary role that the market plays for other businesses. Our experience in the 1980s with insured thrift institutions illustrates the necessity of avoiding expanding risks to the deposit insurance funds and lax supervisory policies and rules. But this necessity has an obvious downside: these same rules limit innovative responses and the ability to take the risks so necessary for economic growth. The last thing we should want, therefore, is to widen or spread this unintended, but nevertheless corrosive, dimension of the safety net to other financial and business entities and markets. It is clear that to do so would not only spread a subsidy to new forms of risk-taking, but would ultimately require the expansion of bank-like supervision as well.

In our judgment, the holding company approach upon which H.R. 10 is premised avoids this pitfall; the universal bank approach cannot.

While financial modernization represents much needed reform, we should not forget that this modernization will, by itself, introduce dramatic changes in our financial services industry. We feel confident that the risks of this type of

reform are manageable within the holding company framework set out in H.R. 10.

There is a final point I want to make since it appears to have driven Treasury's opposition to last year's version of H.R. 10. H.R. 10 would not diminish the ability of the Executive Branch to continue to play its meaningful role in the development of banking or economic policy. Currently, the Executive Branch influences such policy primarily through its supervision of national banks and federal savings associations. H.R. 10 would not alter the Executive Branch's supervisory authority for national banks or federal savings associations, nor would it result in any reduction in the predominant and growing share of this nation's banking assets controlled by national banks and federal savings associations. Indeed, as of September 1998, nearly 58 percent of all banking assets were under the supervision of the Comptroller of the Currency, up from 55.2 percent at the end of 1996. Moreover, after controlling for mergers of like-chartered banks, the number of national banks has increased over the period 1996-98 and the number of state banks has declined.

Furthermore, Congress for sound public policy reasons has purposefully apportioned responsibility for this nation's financial institutions among the elected Executive Branch and independent regulatory agencies. H.R. 10 retains this

balance, and the Federal Reserve does not believe it would serve any useful purpose to alter it. Such action would be contrary to the deliberate steps that Congress has taken to ensure a proper balance in the regulation of this nation's dual banking system.

Conclusion

The markets are demanding that we change outdated statutory limitations that stand in the way of more efficiently and effectively delivering financial services to the public. Many of these changes will occur even if Congress does not act, but only Congress can establish the ground rules designed to assure the maximum net public benefits, protect the safety and soundness of our financial system, create a fair and level playing field for all participants, and assure the continued primacy of U.S. financial markets. For these reasons, the Federal Reserve supports and urges prompt enactment of the financial modernization contained in H.R. 10.

Testimony of

Thomas J. Curry

COMMISSIONER OF BANKS

COMMONWEALTH OF MASSACHUSETTS

on behalf of the

CONFERENCE OF STATE BANK SUPERVISORS

before the

COMMITTEE ON BANKING AND FINANCIAL SERVICES

United States House of Representatives

February 11, 1999

Good morning, Chairman Leach, Representative LaFalce, and members of the Banking Committee. I am Thomas J. Curry, Commissioner of Banks for the Commonwealth of Massachusetts, Vice Chairman of the Conference of State Bank Supervisors and a member of the Federal Financial Institutions Examination Council state liaison committee. I am pleased to be here today to share the views of CSBS on H.R. 10, the "Financial Services Act of 1999."

CSBS is the professional association of state officials who charter, regulate and supervise the 6,633 state-chartered commercial banks, 330 BIF-insured savings banks, and more than 400 state-licensed foreign banking offices nationwide.

Mr. Chairman and Representative LaFalce, CSBS applauds your long-standing support of the dual banking system. Your continuing efforts and those of your colleagues on this committee to defeat state bank exam fees are very much appreciated by the nearly 7,000 state-chartered institutions we regulate.

We also commend you for your tireless efforts to modernize our financial system. CSBS supports expanded bank activities that provide a broader range of choices to the consumer, enhance competition, and do not jeopardize safety and soundness. CSBS believes that any changes to our current system must preserve safety, soundness and public confidence. The keys to accomplishing this are: enhancing competition in the

financial marketplace; offering opportunities for innovation in products and delivery systems; providing flexibility to regulators and bank management; and allowing the market to promote efficiency by preserving investor choice.

Regulation should not drive new products and services or new delivery systems; rather, the market should drive changes in the industry. As regulators, we must supervise these changes to safeguard consumers, depositors and taxpayers. Regulation in a market-driven environment can promote safe and sound behavior by supplying incentives for well-managed institutions, and by limiting the activities of unhealthy banks.

H.R. 10 does much to advance these goals.

STATE AUTHORIZATIONS OF EXPANDED BANK ACTIVITIES

Under our dual banking system, states and the federal government independently charter and regulate financial institutions. The vast majority of banks -- 74% of the industry -- are state-chartered. They hold approximately 45% of all assets and deposits in the U.S. banking system.

A bank's charter determines its powers, and states have traditionally authorized a wide range of powers for their state-chartered banks. In fact, Section 20 of the Glass-Steagall Act has never applied to state banks that are not members of the Federal Reserve System. Today, there are 5,651 "nonmember" banks – a vast majority of the industry. However, interpretations of the Bank Holding Company Act have prevented most of these institutions from being able to exercise their authorized powers fully. State-chartered banks that are not currently members of the Federal Reserve System generally have the option of conducting their state-authorized activities within the bank or through subsidiaries. In fact, many states require their banks to engage in certain activities only through subsidiaries.

For years, state banks have conducted many non-banking activities, within the bounds of safety and soundness as determined by their state supervisors. These activities have primarily been in the area of agency and brokerage: insurance sales, real estate brokerage, sales of uninsured investment products, and travel agency. Forty-four states now authorize discount or full securities brokerage for their state-chartered banks. Twenty-five states allow banks to underwrite municipal revenue bonds; 49 allow bank insurance sales, and 32 of these states allow insurance sales powers beyond those allowed for a national bank. Seventeen states allow their state-chartered banks to sell real estate.

As Congress considers financial modernization at the federal level, the states continue their tradition of innovation by granting new powers and creating new charters for financial institutions. In the past two years, states have acted to expand bank insurance powers in Colorado, Connecticut, Georgia, Illinois, Indiana, Louisiana, Maine, Massachusetts, Mississippi, Nevada, Pennsylvania, Utah, and Vermont. In Connecticut, Illinois, Massachusetts and Pennsylvania, these new laws marked the end of years of anti-affiliation laws that prohibited any kind of bank insurance activity. In Indiana, banks that had been able to sell property and casualty insurance since the beginning of the century now have the authority to sell life insurance.

Last year, Utah enacted legislation to allow broad insurance powers for state-chartered banks. Federal law currently prohibits insurance underwriting activities for all banks, but the Utah law envisions a time when this activity might once again be available for healthy, well-managed financial institutions.

In 1997, in an effort to promote economic development and attract new capital to the state, Maine created a new uninsured wholesale financial institution charter. These institutions will not take deposits, but will be funded through equity and borrowings.

They have trust powers and have investment and lending powers beyond those of commercial banks.

The new community bank charter in Connecticut also seeks to encourage lending to local businesses and consumers, by making it easier for financial institutions to enter the market. This community bank charter requires slightly less capital than a traditional commercial bank charter.

The most dramatic development on the charter front, however, was another charter from Maine. Maine identified the most attractive qualities of all its state charters – the commercial bank, savings bank, savings and loan – and combined them into one premier charter.

Anticipating future changes in federal law, the Maine law eliminates restrictions on ownership of these new institutions, and allows for a broad choice of ownership structures – stock, mutual, limited liability partnerships, limited liability corporations, and limited partnerships.

Until 1991, states were also able to authorize their banks to conduct a wide range of expanded activities as principal. The Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) restricted such state bank activities to those permitted to national banks, unless the FDIC determines on a case by case basis that the activity poses no significant risk to the deposit insurance fund. Under this standard, the FDIC has approved most applications for additional activities by state-chartered banks. The FDIC has recently streamlined this application process, and reduced the requirement for certain expanded activities from an application to a notice for qualifying institutions.

STRUCTURES FOR BANK SECURITIES ACTIVITIES

One concern we have with H.R. 10 is its rollback of state-chartered banks' securities underwriting activities. State-chartered banks should continue to have the option of conducting securities activities in bank subsidiaries, as law in many states currently allows, or through holding company affiliates. H.R. 10 may jeopardize the balance of our dual banking system by reducing state banks' ability to offer their customers expanded products and services in the most cost-effective way.

The bill rolls back existing authority in 16 states for securities underwriting in a subsidiary, grandfathering only existing activity. This would preempt state authority.

Under our current structure, we are not aware that the activities of any state bank's securities subsidiaries have threatened the deposit insurance fund. Given this experience, we should not dismantle this structure.

The new affiliate structure proposed by the bill would offer important new opportunities to member banks and bank holding companies. However, we feel strongly that this should not be the only option available to state-chartered banks that want to engage in these activities.

BENEFITS OF STATE INNOVATIONS

A key benefit of our dual banking system is that it provides for innovations at both the state and the federal level. In fact, state initiatives have spurred most advances in U.S. bank products and services. Everything from checking accounts to adjustable-rate mortgages, from electronic funds transfers to interstate branching, originated at the state level. A state bank was the first to offer a NOW account (which originated in Massachusetts), and state banks developed the automatic teller machine. States were also first in allowing banks to adopt the Subchapter S Corporate status. Because states can act individually to authorize new products and services, banks in other states and the federal banking agencies have an opportunity to learn from these state-chartered banks'

experience. When new activities emerge one state at a time, systemic risk is minimized. If an activity proves too risky, unprofitable, or harmful to consumers, it is much easier for a single state to change its law than for the federal government to reverse itself.

When changing federal law, as is proposed in H.R. 10, we must preserve the states' ability to experiment independently with new products and services, new structures and new delivery methods. State-authorized powers are the bridge that brought us to this point. Now that we are here, we must not burn that bridge. Federal law should not become the only avenue for innovation in the banking system. Otherwise we will close the book on the dual banking system that has served our country, and our economy, so well for so long.

PRESERVATION OF REGULATORY FLEXIBILITY

Regulation and supervision of banking in the United States, like banking itself, evolved over time, largely in reaction to historical events with no grand structure or design. As a result, the United States today has a multiplicity of supervisory agencies at both the state and federal levels.

Critics of this system of multiple regulators have called it redundant and inefficient. On the contrary, CSBS believes that, with coordination and cooperation, a diversity of regulators actually strengthens the U.S. banking system by providing an environment that nurtures innovation and flexibility in both regulation and banking products and services. In protecting the safety and soundness of the nation's banking system, we believe that two sets of eyes are better than one. The comparatively lower failure rate for state banks versus national banks during the late 1980s and early 1990s, we believe, demonstrates the particular value that is brought to the examination process by the cooperation of the states, the FDIC, and the Federal Reserve.

The lack of a monopolistic regulatory environment has also created a healthy dynamic tension among regulators, resulting in a wider range of products and services available to consumers, lower regulatory costs, and more effective, more responsive supervision.

Choice in the regulatory environment can have many of the same benefits that it has in the business environment. Knowing that banks have a choice, regulators work smarter and more effectively. Dedication to the safety and soundness of the financial institutions we regulate is our goal, and it is essential that we have the necessary resources

to ensure safety and soundness. Without an alternative, however, an expensive, inefficient and arrogant regulatory regime could easily develop that would burden and restrict financial institutions – disadvantaging them in the marketplace – resulting in a less healthy banking system.

SUPERVISION OF NONBANKING ACTIVITIES – RISK-BASED SUPERVISION

As we learned all too well during the savings and loan crisis of the 1980s, the key to expanding powers is effective supervision. Therefore, we believe that the state and federal banking agencies must supervise any banking organization that engages in additional activities from the top down, and from the bottom up. CSBS is pleased that H.R. 10 recognizes this regulatory principle.

The structure in H.R. 10 is appropriate because it does provide for comprehensive supervision at the top. This concept is familiar to this committee, as you codified it in the "Foreign Bank Supervision Enhancement Act of 1991," in response to the failure of BCCI.

CSBS believes that the Federal Reserve, with its joint responsibilities of protecting the safety and soundness of the banking system and promoting stability and growth for

the economy, is well suited to serve in this umbrella regulatory role for the new qualified bank holding companies. Virtually all of the large holding companies now operate and are managed as integrated units, especially in their management of risk. As it is managed on a comprehensive basis, this global holding company risk must be supervised on a comprehensive basis as well.

Effective comprehensive supervision of the entire organization – using the concept of risk-based supervision – allows regulators to protect safety and soundness while minimizing regulatory burden. Experience shows that enacting rigid requirements into statutory language almost inevitably creates loopholes that may be exploited, while limiting the regulators' flexibility to address these loopholes. Regulatory guidelines, which regulators could adapt for institutions on a case-by-case basis, are a better approach than rigid statutory requirements. The types of restrictions appropriate for large institutions may not be suitable for small ones, and *vice versa*.

A consolidated model of supervision, with a risk-based approach to examination and regulation, allows for an expansive view toward powers while protecting supervisory authority to guard safety and soundness. The risk-based model, developed and accepted by the Federal Reserve Board, the FDIC, and the state banking supervisors, allows a

tailored approach to supervision that focuses examination resources on a bank's greatest risks. This approach – using computer aided analysis -- allows examiners to look beyond the traditional "snapshot" view of a bank's condition to how an institution with a variety of business activities will respond to changing market conditions.

As a state bank supervisor, I have observed that this risk-based model has allowed the state system to simultaneously bolster regulation for safety and soundness, expand powers, and – by forcing us to focus and coordinate our resources -- reduce regulatory burden. These efficiencies in regulation have developed because of our system of multiple regulators.

COORDINATED SUPERVISION

We are not comfortable with a "functional regulation" model that disregards the bank regulators' responsibility for the overall safety and soundness of the entire organization. As we have seen throughout this debate, interested parties do not agree on exactly what "functional regulation" is, or on how it would work in practice. We would like to reiterate our conviction that comprehensive supervision at the top of an organization is absolutely necessary to protect insured deposits, consumer interests, and – for very large organizations -- the stability of our financial system as a whole. To

accomplish this, coordination and cooperation is necessary among all regulators involved with an institution.

To further this necessary cooperation and coordination, we have formed joint task forces with the National Association of Insurance Commissioners (NAIC) and the North American Securities Administrators Association (NASAA). The purpose of these task forces is to share information and coordinate our supervision of financial institutions toward our mutual goal: a wide range of safe, responsible, accessible financial services for our states' citizens. Sixteen states, including Massachusetts, have independently developed plans for the coordinated supervision of bank insurance sales by state banking and insurance departments.

Forty-nine states currently allow bank insurance sales, and 32 allow insurance sales powers beyond those permitted for national banks. The issues now under discussion are how to regulate these banks, and the appropriate extent of consumer protection provisions. We believe the system of "coordinated regulation" now developing at the state level -- which recognizes the role of both the bank and insurance regulator -- could serve as a model for all banks selling insurance.

Activities of Foreign Banking Offices

A significant portion of the assets that state bank supervisors oversee are held by foreign banks. These international banks operating in the United States have different structures; most are wholesale, uninsured operations that are prohibited from taking insured deposits.

We believe that "national treatment" means parity of treatment, not identical treatment. H.R. 10 in most cases attempts to provide national treatment to foreign banking organizations operating in the United States. However, to more clearly achieve this goal, some revisions to H.R. 10 may be necessary. This is the right thing to do. While some foreign banking organizations operate under different structures from their domestic competitors, parity of treatment is important. These international banks, through their operations in the United States, add important sources of liquidity to our markets and provide many opportunities for US companies to export their products to overseas markets.

State Savings Bank Provisions

We strongly support H.R. 10's provision to repeal Section 3(f) of the Bank Holding Company Act.

Congress approved Section 3(f) of the BHCA in 1987 to allow savings banks to engage in activities allowed under state law. This provision also grandfathered savings banks that were providing savings bank life insurance.

However, subsequent court rulings and Federal Reserve Board interpretations have made these savings bank-specific provisions unnecessary. Section 3(f) was intended to be a special grant of authority for savings banks, not a restriction. Repeal of these provisions would bring the regulation of savings banks in line with the regulations governing all other financial institutions in a bank holding company structure.

CONCERNS ABOUT MODERNIZATION WITHOUT LEGISLATION

CSBS does have some concerns about the course financial modernization will take without the input of the Congress. Congress has an obligation to create an appropriate regulatory structure for the new financial organizations already emerging in the marketplace.

The growing number of unitary thrift holding company applications by entities outside of banking raise questions in four principal areas.

First, what requirements does the Office of Thrift Supervision (OTS) contemplate for entities that plan to operate outside a traditional branch network? Second, does the OTS plan to evaluate its overall supervisory approach to unitary thrift holding companies, given the significant increase in applications and the size and scope of the non-bank firms applying for unitary thrifts? Third, given the rapidly growing number of non-bank commercial firms that are expanding into banking under the federal thrift charter, what supervisory policies and procedures will the OTS follow to minimize potential risks to the Savings Association Insurance Fund (SAIF), including risks created by the activities of commercial affiliates? Finally, how does the OTS intend to apply the federal Community Reinvestment Act (CRA) to these entities?

These four issues have important implications for the chartering and regulation of thrift institutions, the safety and soundness of the SAIF, and the application of CRA to insured depository institutions.

We have posed these questions to OTS Director Seidman, and appreciate her thoughtful response. We particularly commend the OTS for acknowledging the need to review its supervision of unitary thrift holding companies. We also appreciate that the

OTS acknowledged some of these concerns in the approval of the State Farm application for a unitary holding company charter.

Current federal policy allows for the expansion of thrift powers by non-banking commercial firms while leaving the state equivalent to the federal thrift charter at a competitive disadvantage.

CSBS, however, believes that any legislative proposals addressing concerns about the unitary thrift charter should be forward looking, and enable competitive opportunities for all financial institutions.

Additionally, we strongly support the provision in H.R. 10 calling for publication in the Federal Register of any preemption of state law by the Office of Thrift Supervision. We believe this provision – which does not in any way affect the agency's authority -- is clearly consistent with the Congress's continuing pursuit of a "government in sunshine." There is no arguable defense for preemption to be shrouded in mystery.

In fact, we believe that this publication notice requirement will help states recognize which of their laws and regulations might need modernizing.

CONCLUSION

State bank supervisors are an integral part of this nation's bank regulation system. State regulation and supervision is professional, cost effective and efficient. State banks are well capitalized, profitable, and serving their customers. Restriction of state powers, state bank structures, and state regulation weakens the system as a whole. Preserving the authority of each state to decide the bank structure, products and services that best suit their citizens' needs, strengthens the system.

We believe that H.R. 10 is a strong beginning to modernizing our federal banking system. It recognizes that the lines between traditional banking and other financial services are disappearing. It provides for a system of comprehensive oversight. We look forward to working with you, Mr. Chairman, and with the other members of the Committee, in adapting our dual banking system for the 21st century.

I would be happy to answer any questions the Committee may have.

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TESTIMONY OF

THOMAS E. GEYER
Commissioner of Ohio Division of Securities
Chair, Securities Activities of Banks Project Group

on behalf of the
North American Securities Administrators Association, Inc.

before the

HOUSE BANKING AND FINANCIAL SERVICES COMMITTEE

U.S. HOUSE OF REPRESENTATIVES

HR 10, "THE FINANCIAL SERVICES ACT OF 1999"

February 11, 1999

INTRODUCTION

Mr. Chairman and Members of the Committee:

I am Tom Geyer, Commissioner of Securities for the State of Ohio, and I appreciate the opportunity to discuss several important issues associated with HR 10, The Financial Services Act of 1999 ("Proposed Act") on behalf of the North American Securities Administrators Association ("NASAA").[1]

I applaud your determination to hold hearings early during this session of Congress and to make enactment of HR 10 a key priority of the House Banking Committee.

NASAA believes comprehensive, congressionally-directed financial services modernization is appropriate and, in fact, overdue. Such modernization is essential for American institutions that wish to compete successfully in the global market place. But we must keep in mind that sweeping financial services reforms will profoundly affect millions of individual investors across the United States.

While I am testifying today on behalf of NASAA, I also represent individual investors, like my wife, who is also an attorney; my father, a schoolteacher in Columbus, Ohio; my Aunt Pam, a single mother of two in Elizabeth City, North Carolina; and my grandfather, a retired veterinarian in Hamilton, Virginia. As I express NASAA's position on HR 10, I will describe what we believe the legislation's impact will be on retail securities customers. I would respectfully suggest it is incumbent upon the Congress to judge the impact that any reform effort will have on individual investors. We hope that our expertise and experience as state securities regulators will be useful to you.

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[1] The oldest international organization devoted to investor protection, the North American Securities Administrators Association, Inc., was organized in 1919. It is a voluntary association with a membership consisting of the 65 state, provincial and territorial securities administrators in the 50 states, the District of Columbia, Canada, Mexico and Puerto Rico. In the United States, NASAA is the voice of the 50 state securities agencies responsible for grass-roots investor protection and efficient capital formation.

There is no denying we have moved from a nation of savers to a nation of investors. Americans have put more of their savings in mutual funds than in insured bank accounts.[2] With a record number of households investing in the securities markets, investor protection, which is the basis for confidence in the U.S. markets, has to be a top priority as you move forward with this legislation.

The percent of adults invested in the stock market has doubled from 21% in 1990 to 43% in 1997; the amount of new money invested in stock market mutual funds skyrocketed from $12.8 billion in 1990 to $231 billion in 1997; and the number of investment clubs has gone from only 7,085 in 1990 to an expected 37,129 in 1999.[3]

Reform of the Social Security Trust Fund is an issue of utmost importance to most households and nearly all of the proposals to reform the social security system involve investing a portion of the Trust Fund in private investments. Whether or not this is the approach ultimately taken, all Americans need to have the assurance the securities products they are purchasing are regulated in the identical fashion no matter if they are purchased at a brokerage firm or a bank.

The most basic purpose of the securities laws is to protect people from people. The U.S. securities industry has not only benefited, it has thrived as a result of the existing structure of shared regulation among the states, the Securities and Exchange Commission ("SEC") and the self-regulatory organizations ("SROs"). Our federal counterparts at the SEC tend to focus upon the oversight of large corporate offerings and the globalization of the marketplace. State securities regulators, on the other hand, are closest to the investing public and serve as the local cop on the beat.

This regulatory system is so effective that the U.S. enjoys a capital marketplace that is the absolute envy of the world. I suggest to you that we have the most successful securities market on the planet *because of the* complementary state-federal securities regulatory system that is in place, *not in spite of it.* In other words, my wife is willing to put money into her law firm's 401(k) plan because she knows there are securities laws designed to protect her. And my father, the schoolteacher, puts his hard-earned money

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[2] Investment Company Institute; May, 1998, Federal Reserve Bulletin.

[3] Sources: National Association of Securities Dealers, Investment Company Institute and the National Association of Investors Corp.

in an Individual Retirement Account because there are laws that ensure the securities marketplace will be honest and fair.

The federal/state regulatory system requires the licensure of people selling products, compels the entities to provide full and fair disclosure about securities offerings and provides the surveillance of the people who operate the securities markets.

The states have led numerous enforcement actions especially in the area of micro-cap fraud. Most importantly, we put crooks in jail. During the years 1996 and 1997, there were more than 500 criminal convictions for violations of state securities laws.

Our constituents, like yours, are small investors who are saving to pay for their retirement, their children's college education or to purchase a home. They may be first time investors who purchase their securities either through a bank or a broker-dealer. Because banks may be the only financial institution they ever dealt with, investors will probably not be aware that the bank is not subject to many federal and state securities laws.

The states have experience with streamlining regulation, and know firsthand that with true functional regulation it is possible to bifurcate without weakening regulatory oversight or unduly confusing the marketplace. Our experience of the last several years has taught us "Perfection is the enemy of the good." Although we are very supportive of the Committee's efforts to achieve financial services reform, this bill's impact on investor protection causes us to have serious concern.

FUNCTIONAL REGULATION

Our main message to you today is that NASAA strongly supports and upholds the ideals of functional regulation of securities activities and products. However, the regulation must be identical, not merely comparable or somewhat similar regulation to be truly "functional." We welcome banks, as well as insurance companies, into the securities business and would respectfully suggest that they be subject to the same complementary state/federal securities oversight system. We do not believe, for example, that banking regulators could, overnight, create enforcement divisions to monitor sales practices as the NASD Regulation ("NASDR"), the SEC and

the states do currently. Even if they could it would constitute unnecessary duplication.

Mr. Chairman, NASAA believes that the SEC and state securities regulators should be the only primary regulators of securities activities regardless of the legal structure of the entity engaging in such activities. Bank securities activities aimed at retail investors must be subject to the vital investor protections contained in federal and state securities laws.

Residents of our states investing in securities should receive the same disclosures and have the same investor protections whether they invest through a broker-dealer, a bank, an insurance company or a mutual fund. Employees who sell securities should be subject to the same licensing qualifications whether their employer is a bank, an insurance company, a securities firm or something else.

Section 104

HR 10 will fundamentally impact the complementary federal-state securities framework. Specifically, section 104(b) calls for wholesale preemption of state securities law with respect to the activities that are authorized by the Proposed Act.

Over the past few years NASAA has successfully fought to preserve state securities enforcement authority in both the National Securities Markets Improvement Act of 1996 and the Securities Litigation Uniform Standards Act of 1998. With our nation's securities markets at all-time highs, state and federal regulators are faced with a potential "bull market in fraud" in the micro-cap market and our full enforcement arsenal must be maintained if not strengthened.

We have worked with the House and the Senate to specifically preserve state antifraud authority in Section 104. I note the preservation language is included in Section 104(d) and for that NASAA is most appreciative. We would respectfully observe, however, there appears to be confusion created between this preservation language and Section 104(b)(4)(C). We urge you to make the preservation of state securities anti-fraud enforcement jurisdiction clear and unequivocal.

Regulatory Deference

NASAA supports appropriate regulatory deference to reduce any burden on the regulated community. In previous testimony, NASAA noted an oversight in Section 111 of the Proposed Act that required banking regulators to defer to state insurance regulators for insurance examinations and to SEC for registered broker-dealers and SEC-registered advisers. There was no deference to state securities regulators for certain broker-dealer exams or to examinations of state-registered advisers in last year's bill.

Again, we appreciate your recognition of this oversight and the correction made resulting in an improved bill that avoids duplicative examinations by securities and banking regulators.

BANK/SECURITIES ACTIVITIES

We recognize the importance and gravity of the broad changes the Proposed Act would bring to our financial system and institutions. Given our central mission of individual investor protection, we urge you not to lose sight of the day-to-day impact the Proposed Act would have on individuals, on both the consumers who would buy investments at banks and those bank employees who would offer and sell the securities to them.

Under current law, most consumer-level securities activities occurring at banks are provided by state and federally registered affiliated or third-party broker-dealers and their registered salespeople. We urge you for a moment to focus on those salespeople, and the system they would work under if the Proposed Act is enacted.

Today, these sales agents must apply for licensing with the securities agencies of the states where they work. They become subject to a comprehensive and time-tested system of regulation that may include suspension or even revocation of their privilege to do business if they violate those regulations. The SROs oversee them in a similar manner from the national level. Agents are also subject to private civil action in the case of violations under state, federal and SRO regulation, often pursued in arbitration. Failure to pay an arbitration award to an investor can result in suspension or revocation of their privilege to do business.

Under the Proposed Act, the system of affiliated or third party broker-dealers and agents would be preserved. This is consistent with our position of functional regulation, which we support.

However, the complex list of exemptions from the federal definition of "broker" and "dealer," coupled with preemption of state securities laws, would create a largely unregulated "parallel universe." Bank employees would constitute a sales force selling a family of investments to consumers, although in most cases, these salespeople would have filed no application for registration with state securities regulators. Further, there would be no screening of the salespeople, and state securities regulators would not be empowered to suspend or revoke their privilege to do business later if they abused their customers.

An SEC report recently stated, "Licensing authority enables states to identify and prevent those individuals who present a serious risk to their citizens from entering or remaining in the industry. Anti-fraud authority by itself does not give regulators the tools they need to detect and deter sales practice abuses and fraud."[4]

Section 201/202

The federal securities laws that are left in place after the preemption of state law are further limited by provisions in Title II of HR 10. At first glance, sections 201 and 202 of the bill attempt to at least make banks subject to the federal securities laws by eliminating the blanket exemption for banks from the federal definition of "broker" and "dealer." This blanket exemption was put into the Securities Exchange Act of 1934 at a time when the limited bank securities activities were tightly circumscribed by the then one-year old Glass-Steagall Act.

While purporting to extend the federal securities law to bank securities activity, Sections 201 and 202 actually exempt from federal securities law a significant level of securities activity that will take place everyday between a bank and individual investors like my wife, my father, my aunt and my grandfather. We have no quarrel with codifying a bank's ability to engage in securities activities that consist of traditional banking functions.

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[4] U.S. Securities and Exchange Commission Study of State Licensing Requirements for Associated Persons of Broker-Dealers; October 10, 1997, p. 48.

However, Sections 201 and 202 go far beyond preserving traditional banking activities and certain provisions are confusing, at best.

Section 201 of the Proposed Act amends Section 3(a)(4) of the Securities Exchange Act and creates exceptions for certain activities conducted at banks. NASAA commends lawmakers for crafting the exception for Third Party Brokerage Arrangements to require specific contractual obligations that are very similar to NASD Rule 2350 for registered broker-dealer activity on bank premises. However, there are some differences which you may want to address. One difference is the NASD requirement to include disclosures of "not FDIC-insured," "no bank guarantee," and "may lose value" in advertising or promotional materials. Similar language is not required in bank advertisements of its brokerage services to satisfy the exception in the Proposed Act. Another distinction is prior to opening an account, the NASD mandates disclosure, orally and in writing, to the investor that the securities products are provided by a "broker" or a "dealer" and not by the bank. HR 10 only requires the bank to inform the customer of similar information but does not mandate how it is communicated.

After examining the securities an unlicensed sales force could sell and the transactions in which they could engage, we fear the result of the exemption list would amount to "dysfunctional regulation." Every bank in the United States could effect 500 securities transactions with consumers without regard to licensing or registration. In Ohio, there are approximately 1100 financial institutions — a quick calculation reveals that this de minimis exception would result in over 500,000 securities transactions on an annual basis in Ohio alone that would be completely outside the securities regulatory framework. Under the Proposed Act, state securities law has been preempted; and pursuant to this proposed exception, the federal securities laws do not apply either.

This is a vague and unmanageable premise. Would there be a counter on the wall of the home bank to keep track of all the salespeople at all the branches as they near the 500 mark? If state licensing and registration have benefit today — and clearly, they do — why should your parents, friends or children be less protected for transactions 1 through 500 than for transactions 501 and after? And what happens at number 501? We believe the proposal is unworkable and impractical, and we must find another solution.

In addition to the 500 "free" transactions per bank per year, banks and their unlicensed salespeople would be empowered to sell a long list of investments without ever invoking the registration requirement. Some of these investments are arcane, some are fairly innocent, others are limited to a sophisticated, institutional clientele and several could be sold to any consumer. Selling the products at banks concerns us. The list includes these items:

- all exempt securities (under section 3 of the Securities Act of 1933) (this includes all municipal bonds and church bonds),
- private securities offerings,
- "traditional banking products" (including loan participations),
- derivatives involving virtually any commodity, including foreign currencies, and
- asset-backed securities.

It is hard to understand why any retail municipal or church bond brokerage firm or salesperson would remain subject to SEC, SRO and state jurisdiction if all they need do to avoid that regulatory system is run transactions through a bank. Given our experiences in these areas, a reduction in registration and oversight of the municipal and church bond area would be perilous.

Under the Proposed Act, bank employees selling private placement securities would be subject to the barest regulation by an SRO and apparently no regulation by the states. Once again, our experience leads us to conclude that such an approach would be tantamount to reducing regulation where, in fact, more is already needed. State review of the issuance of private placement securities has been limited significantly in recent years, and we are concerned about the outcome. Under this proposal, state oversight over those salespeople who sell private placements would now be virtually eliminated. As a result, investor protection would be jeopardized.

Allow me to read excerpts from a handwritten letter attached to this testimony recently received by the Ohio Division of Securities (the names have been omitted to protect the innocent):

> On March 6, 1998, I went to "X Bank" with over $20,000 in $100 bills I had saved for a few years. I told "Bank Representative" I just wanted it in the bank . . . Then she started pushing this "Y Stock" on me . . . She asked me to sign a few times and that was that .. . I kept getting these letters in the mail from "Y Stock" . . . I opened one yesterday and showed it to my dad, and he said I got ripped. I wonder if you can help me with this? I wasn't wise to this stock business.

The materials accompanying this letter reveal that this gentleman is unemployed and received $6,000 annually from Medicare. The "Bank Representative" put over $10,000 into a growth and income mutual fund, an appropriate product for some investors but clearly unsuitable for this gentleman. In fact, the account statement showed that the fund had lost almost 15% of its value during the six months it was owned by this investor.

These are the stories that we see every day as the regulator closest to the investing public. These are the types of transactions that can fall outside the complementary state-federal securities framework under the proposed structure of HR 10.

The grab bag of products available for unlicensed sales under the groupings "traditional banking products," "derivative instruments" and "asset-backed securities" is complex and confusing. To the extent that marketing and sale of these more arcane products by unlicensed people is limited to "qualified" or otherwise sophisticated investors is of some comfort to state regulators, but still a dangerous premise. There is much ambiguity and uncertainty particularly in the derivative instruments area. The debate continues and most would agree that it is unclear and far from a certainty in most circumstances as to whether a particular derivative is or is not a "security."

Even so, we would depend on that distinction to determine whether a bank was or was not a "dealer" and its salespeople agents subject to state registration and regulation. Much greater clarity is required here to provide any semblance of closure on the question. This is most important when a stated purpose of the Proposed Act is to rationalize financial services

regulation rather than allow it to grow even more irrational with uncertain direction.

As state securities regulators, we are also concerned about the alternative regulatory structure that federal banking regulators are to create for the "parallel universe" of unregistered banks and their sales forces. As stated previously, we believe the system of exemptions proposed is "dysfunctional regulation," and oppose it in its current breadth as undermining our established and effective investor protection program. If it is the system we are to have nonetheless, we urge you to be more emphatic in mandating the regulatory structure to be imposed on salespeople by banking regulators.

Under the Proposed Act, banking regulators would not prescreen bank salespeople. A registered broker-dealer agent revoked for municipal bond fraud in Columbus on Monday could go to work at a bank selling the identical securities in Cedar Rapids on Tuesday with none but he the wiser. Even if discovered, what clear authority or mechanisms are set forth for the Comptroller to deny that agent a sales position at the bank or to expel him later?

There is no clear direction to establish an arbitration system. Even a casual examination of the investor redress system already in place in the securities industry will indicate it is complex, costly and extremely resource intensive. Even with a clearly mandated arbitration structure, without a registration or license requirement of some sort, arbitration awards may be made meaningless as well.

In sum, the establishment of a regulatory regime to deal with this new sales force at banks is an enormous undertaking, beyond the traditional scope of federal or state banking regulation. Without clear, emphatic and comprehensive mandates, we fear a void will develop, to the ultimate and entirely avoidable disadvantage of the investors state securities regulators now have the responsibility and power to protect.

Qualified Investors

In general, NASAA believes that certain investors, due to their wealth, institutional nature, or sophistication do not require the protections afforded by federal and state securities laws. Other investors may not fully appreciate

the risks associated with an investment in such securities and the effect that certain disclosure obligations will have on the investment.

NASAA's chief concern with respect to the definition of "qualified investor" in the Proposed Act is the inclusion of "any government or political subdivision, agency or instrumentality of a government who owns and invests on a discretionary basis not less than $50,000,000 in investments . . ."

Many county and local governments will meet this threshold yet not possess the sophistication or knowledge to be appropriately deemed "qualified investors." Many state, county and local government pensions are advised by volunteers or elected or appointed officials who are not principally engaged in the business of investment management.

To remedy, NASAA would respectfully suggest that these government entities should be required to own a greater quantity of investments such as $250,000,000 to increase the likelilhood that professional advisers will manage the portfolio due to its size.

Asset-Backed Securities

The Proposed Act eliminates the blanket statutory exemption for banks from the definition of "broker" and "dealer" currently found in the Securities Exchange Act. It goes on to include various exceptions for specifically described bank securities activities. The effect is to permit banks to engage in the offer and sale, as agent, of "traditional banking products," a definition that includes asset-backed securities.

Asset-backed securities are debt securities "backed" by loan paper, notes, leases or other accounts receivables. The revenue stream from these underlying assets is used to make interest and principal payments owed to bondholders. The safety of the asset-backed security is directly related to the underlying revenue stream. States have seen a number of offerings of asset-backed securities that were securitized by unstable and unreliable revenue streams such as credit card receivables and used car loan agreements. NASAA does not believe that an unregistered entity should be permitted to distribute these risky securities to deposit holders that are not "qualified."

A bank selling asset-backed securities is not presently regulated as a broker-dealer and is not subject to the regulations that provide protection to investors. NASAA does not oppose banks' abilities to sell these securities to qualified investors, assuming that these investors are able to understand and shoulder the risk inherent with the purchase of asset-backed securities.

Our concern is not with banks selling these products to certain "qualified investors," but that few restrictions are being placed on a bank's ability to distribute the securities. NASAA believes the standard in Section 206 of HR 10 is simply too subjective to provide banks with meaningful guidance regarding which investors are "suitable" and which are not.

CONCLUSIONS

Banks are now full players in the securities markets — their involvement in securities activities is no longer incidental or sporadic. Under functional regulation, all securities market participants should be subject to a single set of standards, consistently applied by an expert regulator. This is important to provide consistent investor protections to all customers.

Although I have raised some of NASAA's specific concerns about HR 10, I do want to reiterate our strong overall support for congressionally mandated financial services reform. However, as the process moves forward, we urge you to give additional thought to these items:

- the far-reaching effects of preempting state securities law,

- upsetting the existing regulatory framework that is responsible for the most successful, vibrant and safe securities market in the world, and

- the bill's enormous impact on individual investors.

Mr. Chairman and members of the Committee, NASAA is committed to work with you to ensure the bill that eventually becomes law contains no diminution of protections for our nation's investors. We are available to provide any technical assistance you desire as you continue in your efforts to achieve meaningful financial services modernization.

Thank you again for the opportunity to testify before you today.

Dear Governors Office

On March 6, 1998 I went to Bank, with over $20,000.00 in $100.00 bills I had saved for a few years. I told I just wanted it in the bank. She asked me if I wanted any stocks. I said I would leave it up to her and that I just wanted it in the bank. Then she started pushing this stock on me. She showed me in a booklet where it paid good and averaged good. She asked me to sign a few times and that was that. I kept getting these letters in the mail from and just put them in a drawer. I opened one yesterday and showed it to Rex, my dad and he said I got ripped. I wonder if you can help me with this? I wasn't wise to this stock buissiness.

Steve

Testimony of the
Special Committee on Financial Services Modernization
of the
National Association of Insurance Commissioners

before the
Committee on Banking and Financial Services
United States House of Representatives

regarding
HR 10 and Financial Modernization

February 11, 1999

George M. Reider, Jr.
Commissioner of Insurance
Connecticut

Testimony of George M. Reider, Jr.
NAIC Special Committee on Financial Services Modernization

Introduction

My name is George Reider, and I serve as Commissioner of Insurance in Connecticut. I also serve as President of the National Association of Insurance Commissioners (NAIC). Today, I am testifying on behalf of the NAIC's Special Committee on Financial Services Modernization. The NAIC established this Special Committee in 1996 to assist State insurance regulators as they continue to meet the demands of the Nation's rapidly evolving marketplace for financial products.

First, I want to express our appreciation for the work of the Committee on Banking and Financial Services and the leadership of Chairman Leach on HR 10. We support Congressional efforts to modernize and improve Federal laws that govern how banking, insurance, and securities products are regulated in the United States. Achieving that goal, however, will require that Congress preserve current State regulatory authority to protect all Americans who purchase or depend upon insurance for financial security – including those who rely upon bank-related entities for insurance coverage.

If Not Fixed, HR 10 Will Seriously Undermine Insurance Regulation in the U.S.

As the primary regulators of insurance in the United States, State governments are equal partners with the Federal government in assuring that financial integration of banking, insurance, and securities products is handled prudently. We are concerned that HR 10, as presently written, does not adequately preserve State authority to regulate insurance activities of banks, their affiliates, and even traditional insurers. The bill's defects seem unintentional, but their harmful impact will nonetheless be very real.

Here are three points we ask you to keep in mind when considering HR 10 –

1. There is no Federal regulatory agency for regulating the business of insurance. If the Federal government prevents the States from supervising insurance adequately, this vital consumer protection function won't get done at all.

2. Individual States and their citizens bear the costs associated with regulating insurance providers, including the costs of any insolvencies that occur. State governments thus have a powerful incentive to do the job well, and the record shows they have done so.

3. Please be careful when re-writing Federal banking laws. The use of overly broad language and imprecise drafting can easily undermine essential State consumer protection laws which apply to ALL insurance providers. The potential costs to State governments, taxpayers, policyholders, and claimants could be enormous.

How HR 10 Harms Insurance Regulation

In the name of giving banks and insurers a level playing field, HR 10 directly preempts large chunks of the general consumer protection authority enacted by State legislatures to protect customers and claimants of ANY insurance provider. These important laws do not discriminate against banks, and they are applied equally across the board to every company that chooses to offer insurance products to the public.

Section 104 of HR 10 is the major offender. It prohibits States from doing almost anything which might "prevent or restrict" the ability of banks to affiliate with insurers or engage in the insurance business, even if a bank's activities bring harm to insurers, policyholders, claimants, and taxpayers. As a result of this prohibition, insurance regulators would be blocked from using our normal tools to review and prevent business affiliations or transactions that hurt policyholders and claimants.

The method used in Section 104 to address inequities is completely backward. Rather than targeting specific laws and regulations, it preempts ALL State authority before giving back some strictly limited powers through language that is both unclear and confusing. We cannot imagine that Congress would agree to such a provision if it stripped Federal banking regulators of their basic authority to protect the public and the Federal deposit insurance system.

There are other culprits in HR 10. Two major subtitles in Title III needlessly undermine State insurance regulation, yet have nothing at all to do with creating a level playing field for banks and insurers. Subtitle B overturns State conversion laws for mutual insurers, while Subtitle C creates a new entity to supervise insurance agents. These attacks on the State regulatory system have no place in a bill which explicitly reaffirms that State insurance powers under the McCarran-Ferguson Act are fully preserved.

Real Examples of HR 10's Harmful Impact

1. My home State of Connecticut was involved last year in the regulatory approval process for the merger between Travelers Insurance and Citibank. As Commissioner, I reviewed the proposed business plan and a complete filing of financial and operating data before making a final decision that the merger should be approved. I met my responsibility to fully review the merger on behalf of the public, and the matter was handled expeditiously with no complaints from the companies making the application. Under HR 10, however, I would be automatically prevented from conducting a proper regulatory review of such a large and influential merger affecting insurance consumers in my State.

2. A recently enacted North Carolina law provides another example. After extensive input from citizen groups, the North Carolina insurance department, and Blue Cross/Blue Shield managers, the State's legislature decided that the $2 billion value of the State's Blue Cross/Blue Shield plan should be put into a trust for the benefit of the public if it is ever sold to private interests. If a bank or bank-affiliated insurer were involved in such a sale, this State law, passed to address local concerns having nothing to do with Federal banking laws, would be preempted because HR 10 dictates that no State law may prevent or restrict a bank from affiliating with an insurer.

3. Pennsylvania enacted a new law in 1996 to correct widespread sales and solicitation abuses found during the State's regulatory examinations of companies marketing life insurance products and annuities. The law sets limitations and minimum standards for illustrations used in marketing such products. It also addresses unfair financial planning practices, and prohibits unqualified agents from holding themselves out as financial planners. Under HR 10, Pennsylvania stands to lose this important tool with respect to the solicitation and sale of life and annuity products by financial institutions, even though the need for the law has been established by State regulators.

4. On a broader level, the NAIC has prepared a chart showing more than 50 basic State insurance laws that HR 10 seems likely to preempt if it is not amended. (See attachment to testimony: "Protecting Insurance Consumers in the United States") The chart identifies NAIC model laws that are the basis for most State statutes covering such critical areas as examinations, audits, reinsurance, capitalization, valuation, investments, liquidations, guarantee funds, agent licensing, and holding company supervision.

Preempting these State consumer protection statutes by changing Federal banking laws will inject needless confusion into the insurance regulatory system, at the very least. The extent of State insurance authority – which is now pretty clear – will surely be questioned and tested, not only by banks and their affiliates, but also by traditional insurers which have complied with present laws for many years. It makes no sense to undermine a State regulatory system that has worked very well in preventing massive insurer insolvencies and answering the demands of consumers.

Progress by State Regulators Depends Upon Maintaining Current Authority

HR 10 threatens the substantial progress now being made by State insurance regulators using our existing authority. While Congress and industry have been talking about modernizing financial services regulation, we have been developing and implementing real changes that promote uniformity and efficiency. The process is working because State insurance authority is well defined and accepted under the McCarran-Ferguson Act.

The NAIC is currently working with the Office of Thrift Supervision (OTS), the Office of the Comptroller of the Currency (OCC), and the Conference of State Banking Supervisors (CSBS) to develop written agreements for cooperating and exchanging information on regulatory matters. In December, our Special Committee on Financial Services Modernization considered, subject to final approval, a model consumer

complaint cooperation agreement developed jointly by NAIC and OCC. Separate agreements with OTS and CSBS covering information and cooperation on examination and enforcement matters are expected to be considered and approved soon. When completed, these agreements will serve as models for individual States to use as a basis for establishing ongoing working relationships with Federal and State banking regulators.

Training and education are additional areas where State insurance regulators are cooperating with Federal agencies. The NAIC has arranged all-day meetings with top technical leaders at the Federal Reserve Board, OTS, and State insurance departments. Special training classes are now being designed by NAIC experts to help Federal regulators perform their duties better by working with insurance regulators. Federal and State participants in these hands-on exchanges have all agreed that they are exactly what is needed to make functional regulation work.

State insurance departments and the NAIC are actively implementing an advanced program called State Regulation 2000 that uses the latest technology to allow constant communication and updated data sharing on key licensing, enforcement, and rate filing requirements. We are also promoting uniformity through model laws, and enhancing efficiency by signing declarations of uniform treatment regarding non-resident agents. These administrative declarations exceed the standards in HR 10 by disallowing counter-signature requirements, and establish reciprocity among the majority of States.

In the push to remove marketing and operating restrictions on financial services, Congress must be careful not to prevent States from implementing the actual reforms we are accomplishing today under existing laws.

How HR 10 Should be Fixed

The NAIC and State regulators strongly urge Congress to amend HR 10 so the bill clearly provides that State insurance departments will maintain their traditional powers to supervise all insurance activities, no matter what type of entity offers them to the public. We believe the House Committee on Banking and Financial Services can fix the insurance regulation problems in HR 10 without adversely affecting the consumer and business benefits which the bill's sponsors hope to achieve. Today, we pledge our strong commitment to help you do just that.

1. Limit the Broad Preemption of State Insurance Authority (Sections 104, 308)

Sections 104 and 308 of HR 10 treat State insurance regulators as enemies of banks, rather than equal partners with Federal regulators in assuring that insurance products are financially sound and marketed fairly to consumers.

Section 104 is particularly onerous because its blanket preemption of State authority extends to other sections of HR 10, as well as to all other Federal laws – past, present, and future. We recommend fixing Section 104 by changing its negative language into a positive legislative statement that State regulators are an essential and equal part of the financial regulatory system for ALL entities which engage in insurance. This

statement preserving general State insurance authority should be followed by narrowly constructed exceptions that supersede specific State laws which obstruct the financial integration provisions in HR 10.

The NAIC will gladly provide the House Banking and Financial Services Committee with suitable language that fixes Section 104. Section 308 should be deleted entirely.

2. Delete the NARAB Provisions in Subtitle C (Sections 321- 336)

The National Association of Registered Agents and Brokers (NARAB) is a special interest provision sought by certain industry groups to evade the State regulatory process. It creates by statute an entirely new organization that would substitute its judgment on agent and broker licensing matters for the decision-making of insurance commissioners empowered by State law. NARAB would exercise quasi-official powers to take over the most important tools which State insurance departments have for controlling fraud and abuse by agents and brokers.

We strongly object to NARAB. If it becomes law, there will be a parade of additional industry groups seeking help from Congress to undermine State authority by slipping amendments into Federal laws. We do not believe Congress should subject itself and State governments to a war of attrition regarding the powers we need to meet our regulatory responsibilities.

NARAB is also unnecessary because the NAIC is now implementing well-designed programs which will achieve the same goals sought by NARAB's proponents. If the NARAB provisions become law, there will be needless regulatory confusion, legal problems, and administrative nightmares regarding the extent of its powers and who actually runs the organization. We urge you to delete the NARAB title from HR 10 because it will cause more problems than it is intended to correct.

3. Delete the Mutual Insurer Provisions in Subtitle B (Sections 308, and 311- 316)

Subtitle B is another attempt by special interests to have the Federal government needlessly intervene in State affairs. In this case, the issue is differing approaches by States using their consumer protection authority to help policyholders of mutual insurers. A number of mutual insurance companies, which are legally owned by their policyholders, want to use short-cuts to convert their business operations to stock ownership in order to raise capital and reward management.

Some States have passed laws which allow mutual insurers to redomesticate by changing to stock ownership without getting approval from their existing policyholders. Other States have refused to permit such short-cuts because they believe it treats policyholders unfairly. In both cases, this is a classic example of States being more attuned to local consumer protection issues than the Federal government. There is no reason for Congress to substitute its judgment for those of the individual States regarding the redomestication of mutual insurers.

4. Refine HR 10 to Make State Insurance Regulators Equal Partners

HR 10 has several provisions which set forth the relationships among the Federal Reserve Board and other regulators. Generally, these provisions grant final approval authority to the Federal Reserve when the jurisdictions of regulatory agencies may overlap. We note that the SEC is given final authority where securities is the primary business involved.

State insurance regulators should be granted equivalent authority to have final approval over the matters for which they are the lead regulator. This seems only fair, since States must bear the costs of any insurer failures which may result from decisions made by Federal regulators.

Conclusions

Three industries – banking, securities, and insurance – are covered by HR 10. Of the three, insurance is the only industry which is entirely supervised by State governments with no Federal financial guarantees. We take pride in our work, our record of accomplishments, and our ongoing efforts to keep abreast of changes in the marketplace which affect insurers and consumers.

As banks increasingly enter non-banking businesses, they have sought to preempt State laws and regulations which they believe are unfair, as well as inconvenient to the ways they are used to doing business in the world of banking. They must realize when they choose to enter insurance that it is a very different business, with different risks and regulatory needs. State insurance regulators and the NAIC will treat bank-related insurance providers the same as any other provider, but we will also insist on applying our generally-applied State consumer protection laws to assure that solvency and fair market conduct requirements are met by ALL insurance providers.

Some people have framed the political debate over financial modernization as a conflict between Federal and State regulation, or between the banking and insurance regulatory systems. The real issue, however, is whether insurance-related activities of banks will be regulated at all if Federal law prevents the States from doing the job. The Federal Reserve Board, OCC, and OTS have each said they do not intend to regulate insurance. If we are prevented from doing it, who will?

We want to continue keeping unsound or rogue insurance operations from damaging consumers, banks, and insurance companies. Doing that job will also protect Federal and State governments from unnecessary financial exposures caused by weak and insolvent institutions. Accordingly, State insurance regulators and the NAIC ask the Committee on Banking and Financial Services to help us by fixing HR 10 to preserve the authority we will need to get the job done.

PROTECTING INSURANCE CONSUMERS

IN THE UNITED STATES

- Insurance comes in many varieties, including life, health, auto, home, mortgage, credit, corporate casualty, and crop insurance

- All insurance policies have two things in common –

  - Customers pay money to insurers for insurance policy coverage

  - Insurers pay money to customers when claims are made under a policy

- Insurance regulators supervise this process in order to –

  - Protect the money customers pay to insurers

  - Assure that policyholders and claimants receive the insurance payments they are due

- HR 10's preemption of State laws guts the ability of insurance regulators to protect insurance consumers in the United States

WHEN CUSTOMERS PAY MONEY TO INSURANCE COMPANIES . . .

➢ The purpose of insurance regulation is to

- Safeguard customer premiums
- Monitor the financial stability of insurers
- Assure fair sales practices and customer treatment

➢ Many laws and regulations used by State insurance departments to protect consumers are based upon NAIC model laws and regulations.

➢ These are the NAIC model laws and regulations that would be affected by HR 10:

NAIC MODEL LAWS AND REGULATIONS	Safeguard customer premiums	Monitor the financial stability of insurers	Assure fair sales practices and customer treatment	Would HR 10 preempt some or all of this law / regulation?
1. Third Party Administrator Statute	X	X	X	YES
2. Model Rule (Regulation) Requiring Annual Audited Financial Reports *	X	X		YES
3. Agents and Brokers Licensing Model Act			X	YES
4. Agents Continuing Education Model Regulation			X	YES
5. Single License Procedure Model Act			X	YES
6. Managing General Agents Act *		X		YES
7. Investments of Insurers Model Act (Defined Standards Version)		X		YES
8. Investments of Insurers Model Act (Defined Limits Version)		X		YES
9. Risk-Based Capital (RBC) Model Act *		X		YES
10. Organization and Ownership of New Insurance Companies		X	X	YES

NAIC MODEL LAWS AND REGULATIONS	Safeguard customer premiums	Monitor the financial stability of insurers	Assure fair sales practices and customer treatment	Would HR 10 preempt some or all of this law / regulation?
11. Business Transacted with Producer Controlled Property / Casualty Insurer Act*		X	X	YES
12. Consumer Credit Insurance Model Act and Regulation			X	YES
13. Creditor-Placed Insurance Model Act			X	YES
14. Model Regulation to Define Standards and Commissioner's Authority for Companies Deemed to be in Hazardous Financial Condition *	X	X		YES
15. Model Law on Examinations *	X	X		YES
16. Insurance Holding Company System Regulatory Act and Regulation *	X	X		YES
17. Life and Health Insurance Guaranty Association Model Act *			X	YES
18. Post-Assessment Property and Liability Insurance Guaranty Association Model Act and Plan of Operation*			X	YES
19. Insurers Rehabilitation and Liquidation Model Act *		X		YES
20. Administrative Supervision Model Act		X		YES
21. Life Insurance Disclosure Model Regulation			X	YES
22. Life Insurance Illustrations Model Regulation			X	YES
23. Premium Financing of Life Insurance for College Students Model Regulation or Guidelines			X	YES
24. Replacement of Life Insurance and Annuities Model Regulation			X	YES
25. Long-Term Care Insurance Model Act and Regulation			X	YES

NAIC MODEL LAWS AND REGULATIONS	Safeguard customer premiums	Monitor the financial stability of insurers	Assure fair sales practices and customer treatment	Would HR 10 preempt some or all of this law / regulation?
26. Medicare Supplement Insurance Minimum Standards Model Act and Regulation			X	YES
27. Insurance Information and Privacy Protection Model Act			X	YES
28. Insurance Fraud Prevention Model Act	X	X	X	YES
29. Service Contracts Model Act		X		YES
30. Viatical Settlements Model Act and Regulation			X	YES
31. Property and Casualty Model Rating Law (File and Use Version)		X	X	YES
32. Property and Casualty Model Rating Law (Prior Approval Version)		X	X	YES
33. Credit for Reinsurance Model Act and Regulation *		X		YES
34. Reinsurance Intermediary Model Act *		X	X	YES
35. Life and Health Reinsurance Agreements Model Regulation *		X		YES
36. Standard Valuation Law *	X	X		YES
37. Actuarial Opinion and Memorandum Regulation *	X	X		YES
38. Unfair Trade Practices Act			X	YES
39. Model Regulation for Complaint Records to be Maintained Pursuant to the NAIC Unfair Trade Practices Act			X	YES
40. Model Regulation on Unfair Discrimination in Life and Health Insurance on Basis of Physical or Mental Impairment			X	YES

NAIC MODEL LAWS AND REGULATIONS	Safeguard customer premiums	Monitor the financial stability of insurers	Assure fair sales practices and customer treatment	Would HR 10 preempt some or all of this law / regulation?
41. Model Regulation on Unfair Discrimination on Basis of Blindness or Partial Blindness			X	YES
42. Unfair Discrimination Against Subjects of Abuse in Health Benefits Plan Model Act				
43. Unfair Discrimination Against Subjects of Abuse in Life Insurance Model Act			X	YES
44. Unfair Discrimination Against Subjects of Abuse in Disability Income Insurance Model Act			X	YES
45. Unfair Discrimination Against Subjects of Abuse in Property and Casualty Insurance			X	YES
46. Unfair Claims Settlement Practices Act			X	YES
47. Unfair Property / Casualty Claims and Life, Accident, and Health Claims Settlement Practices Model Regulations			X	YES
48. Rules Governing Advertisements of Accidental Sickness Insurance			X	YES
49. Rules Governing Advertisements of Medicare Supplement Insurance			X	YES
50. Health Information Privacy Model Act			X	YES
51. Rules Governing the Advertising of Life Insurance			X	YES

* All states accredited by the NAIC have enacted a version of this model

WHEN INSURERS PAY MONEY TO CUSTOMERS . . .

- The purpose of insurance regulation is to
  - Assure that companies have the ability to pay claims
  - Assure that companies pay legitimate claims
  - Safeguard consumers' rights to payment / coverage
- Many laws and regulations used by State insurance departments to protect consumers are based upon NAIC model laws and regulations.
- These are the NAIC model laws and regulations that would be affected by HR 10:

NAIC MODEL LAWS AND REGULATIONS	Assure that companies have the ability to pay claims	Assure that companies pay legitimate claims	Safeguard consumers' rights to payment / coverage	Would HR 10 preempt some or all of this law / regulation?
1. Third Party Administrator Statute	X		X	YES
2. Model Rule (Regulation) Requiring Annual Audited Financial Reports *	X			YES
3. Managing General Agents Act *	X		X	YES
4. Investments of Insurers Model Act (Defined Limits Version)	X			YES
5. Investments of Insurers Model Act (Defined Standards Version)	X			YES
6. Risk-Based Capital (RBC) Model Act *	X			YES
7. Organization and Ownership of New Insurance Companies	X			YES
8. Business Transacted with Producer Controlled Property / Casualty Insurer Act*	X			YES

NAIC MODEL LAWS AND REGULATIONS	Assure that companies have the ability to pay claims	Assure that companies pay legitimate claims	Safeguard consumers' rights to payment / coverage	Would HR 10 preempt some or all of this law / regulation?
9. Model Regulation to Define Standards and Commissioner's Authority for Companies Deemed to be in Hazardous Financial Condition *	X	X		YES
10. Model Law on Examinations *	X			YES
11. Insurance Holding Company System Regulatory Act and Regulation *	X			YES
12. Life and Health Insurance Guaranty Association Model Act *	X			YES
13. Post-Assessment Property and Liability Insurance Guaranty Association Model Act and Plan of Operation*	X			YES
14. Insurers Rehabilitation and Liquidation Model Act*	X	X	X	YES
15. Administrative Supervision Model Act	X			YES
16. Long-Term Care Insurance Model Act and Regulation			X	YES
17. Medicare Supplement Insurance Minimum Standards Model Act and Regulation			X	YES
18. Insurance Fraud Prevention Model Act	X			YES
19. Service Contracts Model Act			X	YES
20. Property and Casualty Model Rating Law (File and Use Version)	X			YES
21. Property and Casualty Model Rating Law (Prior Approval Version)	X			YES
22. Credit for Reinsurance Model Act and Regulation *	X			YES
23. Reinsurance Intermediary Model Act *	X			YES

NAIC MODEL LAWS AND REGULATIONS	Assure that companies have the ability to pay claims	Assure that companies pay legitimate claims	Safeguard consumers' rights to payment / coverage	Would HR 10 preempt some or all of this law / regulation?
24. Life and Health Reinsurance Agreements Model Regulation *	X			YES
25. Standard Nonforfeiture Law for Individual Deferred Annuities		X	X	YES
26. Standard Nonforfeiture Law for Life Insurance		X	X	YES
27. Standard Valuation Law *	X			YES
28. Actuarial Opinion and Memorandum Regulation*	X			YES
29. Unfair Trade Practices Act		X		YES
30. Model Regulation for Complaint Records to be Maintained Pursuant to the NAIC Unfair Trade Practices Act		X		YES
31. Unfair Discrimination Against Subjects of Abuse in Health Benefit Plans Model Act		X	X	YES
32. Unfair Discrimination Against Subjects of Abuse in Life Insurance Model Act		X	X	YES
33. Unfair Discrimination Against Subjects of Abuse in Disability Income Insurance Model Act		X	X	YES
34. Unfair Discrimination Against Subjects of Abuse in Property and Casualty Insurance		X	X	YES
35. Unfair Claims Settlement Practices Act		X		YES
36. Unfair Property / Casualty and Life, Accident and Health Claims Settlement Practices Model Regulations		X		YES
37. Viatical Settlements Model Act and Regulation			X	YES

*All states accredited by the NAIC have enacted a version of this model

Consumers Union

Publisher of Consumer Reports

Statement of

Mary Griffin
Insurance Counsel
Consumers Union, Washington Office

Before the

Committee on Banking and Financial Services
House of Representatives

Hearing on

"Financial Services Act of 1999" (HR 10)

February 11, 1999

Washington Office
1666 Connecticut Avenue, Suite 310 • Washington, D.C. 20009-1039 • (202) 462-6262

Consumers Union[1], publisher of *Consumer Reports* magazine, appreciates the opportunity to appear today to present the consumer perspective on the "Financial Services Act of 1999" (HR 10).

Over the past few years, we have supported efforts to modernize the financial services industry so long as such efforts moved in the direction of the consumer, not just the financial services industry. We understand the challenges Congress faces in restructuring the financial services industry to balance the interests of the industry, regulators and consumers. Thus far, we have been disappointed that the balance has been tipped too much in favor of industry and regulators' interests, and not the consumer interest. While last year's efforts held potential to bring a more balanced approach to the restructuring of the financial services market, we believe this bill represents a step backward for consumers. Congress must realize that financial modernization can only succeed if fair treatment of consumers goes hand in hand with the elimination of the walls that separate the industries.

Meeting the Needs of Consumers in a Changing Financial Services Market

Although the restructuring of the financial services market as envisioned under HR 10 will have major impacts on consumers, many of the changes are occurring in the market in the absence of legislation. And rather than being a boon for consumers, consumers have been misled and deceived about the products banks sell and found themselves nickle-and-dimed to death with a plethora of fees. Financial firms have become masters of a marketing frenzy to current and potential customers, invading consumers' mailboxes and telephone lines with abandon and almost no checks on their practices.

Unlike other private industries, as Chairman Greenspan has pointed out, the bank system is not a free market system. Depository institutions enjoy support from taxpayers in several forms, including the deposit insurance system and access to the discount window. Congress should not permit "modernization" to be used as a code word for further catering to the wealthy while leaving out the middle and lower income consumers, making services more and more costly for those people who have the fewest resources.

As banks have become full service financial centers, they have targeted the more wealthy customers who they believe have more fee-generating potential for them. "'Everyone isn't the same anymore,' says Steven G. Boehm, general manager of First Union's customer information center .... After years of casting a wide net to lure as

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[1] Consumers Union is a nonprofit membership organization chartered in 1936 under the laws of the State of New York to provide consumers with information, education and counsel about good, services, health, and personal finance; and to initiate and cooperate with individual and group efforts to maintain and enhance the quality of life for consumers. Consumers Union's income is solely derived from the sale of *Consumer Reports*, its other publications and from noncommercial contributions, grants and fees. In addition to reports on Consumers Union's own product testing, *Consumer Reports* with approximately 4.5 million paid circulation, regularly, carries articles on health, product safety, marketplace economics and legislative, judicial and regulatory actions which affect consumer welfare. Consumers Union's publications carry no advertising and receive no commercial support.

many customers as possible, banks and many other industries are becoming increasingly selective, limiting their hunt to "profitable" customers and doing away with loss-leaders," as the Wall Street Journal recently reported." [2] A multi-tiered structure has formed where the wealthy get better access to services and better deals and the middle and lower income customers are struggling to pay for access and basic services.

First Union employs a red-yellow-green light system to differentiate among customers and weed out the less profitable or "redlighted" customers while giving better deals and fee waivers to the "greenlighted" customers. Many of those customers who were "redlighted" may be called upon in the future to bail out the very institutions that denied them the service and deals they deserve.

What does Congress need to do to assure consumers that the changes to the financial services market will benefit them?

Enforceable Retail Sales Protections for "One-Stop Shopping:" To help prevent confusion and coercion, consumers need:

- effective disclosure of which products banks sell that are not FDIC-insured or guaranteed and subject to risk of loss;
- requirement that sales activities be conducted in an area separate from where banks take deposits and make loans and compensation structures that promote suitable sales;
- anti-coercion rules that require sales people to wait to make sales until after the loan is made to prevent banks from taking advantage of loan applicants;
- suitability rules to ensure the products consumers purchase meet their financial needs; and
- a process for consumers who lose money when banks violate these rules to recover their losses.

While we appreciate and support the inclusion of a package of retail sales protections in the bill, these protections need to be strengthened. For example, the bill fails to include the suitability requirements that were contained in the bill approved by this committee last Congress. In addition, language in section 307(g)(2) creates a "reverse preemption" situation by permitting the federal regulations to be preempted by state laws that are inconsistent or contrary to the regulations. Such language is not necessary and undermines the goal of consumer protection.

Functional Regulation to Ensure Protections Available Regardless of where a Consumer Shops: Banks engaged in securities activities are not subject to federal securities laws because they are exempt from the definition of broker/dealer and investment adviser. Consequently, the investor protection rules issued by the Securities and Exchange Commission ("SEC"), including the ability to receive compensation through arbitration from unscrupulous sellers who violate SEC rules, do not apply. Any financial modernization proposal should do away with this out-dated exemption.

While HR 10 contains provisions that attempt to close this loophole, it falls short of providing consumers with full protection afforded by securities laws. The language

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[2] *Wall Street Journal*, January 7, 1999, p. A1.

contained in the version passed by the House last Congress provides stronger investor protections and is preferable to the approach in this bill. With regard to the regulation of insurance, we are concerned that provisions in the bill could limit the ability of states to enforce their rules on bank insurance activities and tie the hands of states to enact strong consumer protections as needed (see discussion below).

Updating Privacy Laws: As banks, insurance and investment firms merge into huge "money centers," the risk of confidential customer information being shared or sold without the consumer's knowledge or consent becomes great. The consumer concern over financial privacy was demonstrated recently when bank regulators issued the "know-your-customer" proposal and received over 14,000 responses, many of which expressed grave concern about banks collecting information on customers' financial activities. Surveys show that eight out of ten Internet users say that protecting the privacy of their dealings over the Internet is a primary concern.[3] The majority of users also believe that only legislation and enforcement will make most businesses observe good privacy policies.

The Fair Credit Reporting Act (FCRA) contains the only financial privacy protections for consumers and is proving to be deficient because of serious gaps in protection. The Citicorp-Travelers merger is an example of why privacy protections are urgently needed. Not only can Citigroup affiliates share financial information about their over 90 million customers to use for cross-marketing (in many cases without the customer's knowledge or consent), but they also can pool data and create their own databases without complying with the FCRA. To adequately address financial privacy and ensure consumer control over whether and the extent to which information is shared or disclosed about them, Congress needs to do the following:

- close off the loopholes in the FCRA that permit financial institutions to disclose important financial information without the customer's knowledge or consent and create data pools exempt from the protections of the FCRA;
- change the opt-out feature of the law to an "opt-in" opportunity, which ensures consumers control over how and when personal financial information is shared;
- give consumers the power to determine what information the institutions hold on them and what their rights are; and
- obligate banks and other financial firms to protect the confidentiality of customers' financial and personal information and hold these institutions legally responsible when a bank or other financial firm violates the confidentiality standards because of a breakdown or failure to protect the data.

Low-Cost Deposit Accounts: As banks focus more and more of their efforts on attracting upper income consumers to their "one-stop shopping" money centers, middle and lower income consumers are fighting a losing battle against fees. In a 1996 study, *Consumer Reports* identified 100 separate fees that banks now impose on consumers. The size of those charges has been rising at better than twice the rate of inflation, jumping more than 50 percent on checking accounts between 1990 and 1996.

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[3] "E-Commerce and What Net Users Want," survey conducted by Louis Harris and Associates, Inc. and Dr. Alan Westin, June 1998.

Recent Federal Reserve data show that almost half of American families, 48 million households, keep a $1,000 or less balance in their checking accounts. Consumers may have to maintain minimum balances of as much as $750, $1000 or more in their accounts at all times or maintain an average balance of even more if they want to avoid paying substantial fees. In addition to those hard-hit by fees, there are an estimated 12 million households that currently have no bank accounts at all.

Most people need banks, but many cannot maintain the high minimum deposits required to avoid monthly charges. Low-cost deposit accounts, with reasonable service fees and low or no minimum initial deposit or balance requirements, are needed to lessen the financial burden on low and moderate income consumers. The House voted for a bill that included low-cost accounts last Congress. We urge you to reinstate this essential protection.

Meeting the Needs of Communities: The Community Reinvestment Act (CRA) has resulted in demonstrable benefits to low and moderate income communities. While CRA has come under attack, Congress should be at the forefront of fortifying it, not narrowing it. Banks should not be permitted to avoid CRA obligations when their affiliates conduct lending activity. All lending activity conducted by banks and their affiliates should come under the CRA. As insurance companies and securities firms merge with depository institutions, they should come under obligations comparable to the federal CRA and other obligations of the type applied to banks to ensure they too meet the needs of all communities, not just the wealthiest. The insurance and securities industries must be held to account for unfair and discriminatory dealing. The trillions in assets they hold should be put to work to assure the communities where they do business stay vibrant and working.

Ensuring the Authority of States to Protect their Residents

States have long had the authority to regulate businesses operating within their borders. It is essential that states have the ability to enact and enforce laws that protect their consumers, especially as the banking industry is further deregulated.

The need for Congress to preserve the right of states to protect their consumers is greater than ever. Over the past few years, the Office of the Comptroller of the Currency (OCC) has showed a lack of concern about consumer protection by preempting state consumer laws. The OCC has issued opinion letters telling national banks that they do not have to comply with such essential protections as state lifeline banking laws that protect consumers from price gouging on checking accounts and laws that prohibit prepayment penalties when consumers sell their homes and pay off their mortgages. And, with the passage last Congress of the Riegle-Neal Clarification Act (HR 1306), state banks can ignore state consumer protection laws whenever a national bank may do so making it even more important to rein in the OCC.

Rather than including a provision that restates and clarifies the application of state laws, provisions in HR 10 would undermine states' rights. With regard to state regulation of insurance, we are very sensitive to work that was done to develop a compromise that addressed the concerns of the insurance industry. We believe section 104, however, undermines state authority to protect consumers. While no state should prevent a bank

from exercising its insurance authority, we are concerned that "restrict" language is too vague. The "safe harbor" and overly broad nondiscrimination standards could tie the hands of states to enact measures designed to protect consumers from misleading or deceptive practices by banks. We are also concerned that some of the language in section 104 could be interpreted to preempt state laws other than those dealing with insurance and securities While changes were made to the original language to address some of these concerns, section 104 may still be interpreted to affect the applicability of other state laws.

The provisions in Subtitle B of Title III that permit mutual insurers to move to other states to take advantage of "mutual holding company" laws and avoid laws that provide greater protections for policyholders should be deleted. These provisions would enable mutual insurers to convert to stockownership without giving policyholders, who have an ownership interest in the mutuals, their accumulated ownership value. Over the past several months, mutual insurance companies have moved to convert to stock under traditional "demutualization." These transactions demonstrate that mutuals can successfully convert to stock without the aid of the mutual holding company structure, a structure that fails to adequately compensate policyholders.

Guarding the Safety and Soundness of Our Financial System

While banking laws need to be modernized, Congress needs to ensure that they are done in such a way as to preserve the safety and soundness of the banking system. Congress must be vigilant to protect against a repeat of the same mistakes that forced taxpayers to pay billions to bailout the s&l industry.

Keep Banks and Commercial Firms Separate: The separation of banking and commerce should be retained. We oppose permitting federally-insured institutions to combine with commercial interests because of the potential to skew the availability of credit, conflict of interest issues, and general safety and soundness concerns from expanding the safety net provided by the government. The federally-insured deposit insurance system should not be put at risk merely because companies have holdings in commercial firms or want to expand into such businesses. We support provisions in HR 10 that retain the barriers between banking and commercial interests, although we believe the grandfather period should be much shorter.

Minimize Taxpayer Risk: Activities such as insurance and securities underwriting that pose risk should only be permitted through a separately capitalized affiliate. Our understanding of the bill is that such activities are not permitted to be conducted in operating subsidiaries, which we support.

Conclusion

Congress has been tackling financial services modernization for several years. In the meantime, regulators have expanded the powers of banks and the market has experienced dramatic changes. Unfortunately, consumer laws have not kept pace with these changes. We urge you to ensure that as you break down the walls that separate banks and insurance and securities firms, you ensure the market serves the needs of *all* consumers and does not simply cater to the wealthiest.

TESTIMONY OF U.S. PUBLIC INTEREST RESEARCH GROUP (PIRG)
EDMUND MIERZWINSKI, CONSUMER PROGRAM DIRECTOR
BEFORE THE HOUSE BANKING COMMITTEE
ON FINANCIAL MODERNIZATION AND HR 10
HONORABLE JIM LEACH CHAIRMAN
11 FEBRUARY 1999

Chairman Leach, Representative LaFalce and members of the committee: U.S. PIRG is pleased to offer our views on Financial Modernization today. As you know, U.S. PIRG serves as the national lobbying office for state Public Interest Research Groups. PIRGs are non-profit, non-partisan consumer and environmental watchdog organizations with offices around the country.

Consumer groups are not opposed to the concept of financial modernization. Properly implemented, financial modernization could bring benefits to consumers in the form of new products and more competition. However, despite the vast amount of time that was been spent in the last Congress and those before that moving H.R. 10 narrowly through the House and to its consideration once again today before this committee, in our view, the bill still represents a triumph of special interests over consumers, communities and taxpayers.

Here is a summary of our views:

(1) RESTORE LOW COST BASIC BANKING: It is incredible to us that virtually every request by special interests was retained in this year's draft of the bill, but the one and only amendment to protect average consumers from rising banking fees was deleted, even though it had passed both the committee and the full House.

We will ask members to oppose the bill at markup unless the House-passed low cost basic banking requirement as proposed by Representative Waters last year is included in the chairman's mark.

(2) PROTECT PRIVACY: Provisions protecting consumers from privacy invasions caused by unfair and unreasonable personal information sharing by holding company affiliates must be added to the bill so consumers have the right to control access to their personal financial records.

(3) STRENGTHEN GUARANTEE THAT STATE CONSUMER PROTECTION LAWS ARE NOT PREEMPTED: Language preempting the authority of states over "any" activity of banks, must be deleted and replaced with new language guaranteeing that the several states retain authority to protect consumers better, especially where no federal law protects consumers at all, such as in the regulation of unfair ATM surcharges.

(4) SUITABILITY REQUIREMENTS MUST BE REINSTATED: The bill's consumer protections when uninsured investment or insurance products are offered to consumers should be strengthened back to the level that they were when they passed the House. The elimination of suitability requirements is unacceptable.

(5) DELETE INSURANCE REDOMESTICATION GIVEAWAY: The special interest provision on mutual insurance domestication -- a potential multi-billion dollar giveaway from ratepayers to corporate executives and future stockholders without compensation to consumers--

must be deleted. It was flagged last year as a fleecing of the consumer and deleted-- why is it back in the bill?

Additionally, we associate our remarks with those of the community groups here today regarding ways to ensure that financial modernization does not weaken -- but actually extends -- the Community Reinvestment Act (CRA) that protects the flow of credit and financial services into our nation's neighborhoods. We would also point that our organization is extremely troubled by the views of many members of Congress that the mixing of banking and commerce would not result in misallocations of credit and an even more undue concentration of political and economic power than we face today.

Finally, we want to point out that the two Banking Committees have spent so much time on HR 10 that they have neglected consideration of important proposals to protect consumers from other problems in the financial system, including credit card billing practices, the fringe banking industry, debit card liability, and other problems. We have attached a summary of PIRG's Financial Services Platform that outlines critical issues that the committee must find the time to investigate this year.

Introduction

The financial industry is going through an unprecedented period of mergers and acquisitions. Enactment of HR 10 will exacerbate two trends. First, it will encourage the growth of bigger banks generally and second, it will encourage the diversification of bank holding companies into new structures. As has been pointed out, H.R. 10 will legalize the already announced merger of Citibank and Travelers, which is proceeding through loophole and exception. In the view of diverse analysts, merger mania has **not** benefited consumers.[1]

Bigger banks means bigger fees. Both PIRG and Federal Reserve bank fee studies have confirmed that bigger banks use monopoly muscle to charge their customers higher fees than small banks and credit unions do. PIRG's 1997 study of deposit account fees at over 400 banks found a 15% fee gap between high cost big banks and low cost small banks; credit union fees were half those of big banks. PIRG's 1998 ATM surcharging report found that more big banks surcharge non-customers and big bank surcharges were higher. So were the fees big banks charged their own customers to use other owners' ATMs.

Already announced and future mergers will result in less consumer choice and less competition-- that means even higher fees for consumers. Besides sheer size, financial holding companies such as Citigroup pose the question of the "one-stop financial supermarket." In our view, unless H.R. 10's consumer protection provisions are protected and enhanced, captive customers will not only pay higher fees, but might be encouraged to buy unsuitable investment products and unnecessary add-on products while facing potential privacy invasions as various affiliates shared their customer profiles, perhaps inappropriately and certainly without informed consent. The consumer protection principles we outline below will help to limit these consequences.

The following are detailed comments on the issues we have highlighted:

(1) RESTORE LOW COST BASIC BANKING: The Waters Amendment Requiring That Banks Affiliated With Financial Holding Companies Offer Low-Cost Lifeline Bank Accounts Must Be Added Back In

According to the conservative estimates of the Comptroller of the Currency, over 12 million American families do not have bank accounts and the vast majority of these families are low-income.[2] In our view, the 1998 House-passed bill's requirement that banks offer lifeline accounts will help solve this problem. Incredibly, no current federal law requires federally insured banks to offer low-cost bank accounts. As both PIRG and the Federal Reserve Board have pointed out in recent studies, bank fees are rising, and are highest at bigger banks.[3]

Worse, the consumers who cannot afford bank accounts end up as customers of fringe bankers ranging from check cashers and pay day loan operators to rent-to-own stores, high cost mortgage lenders and pawn shops. These largely unregulated firms are notorious for charging egregious fees to cash checks or borrow money.[4]

Consumer and community groups have listened, ever since deregulation began in 1980, to the banks and their claims that lifeline bank regulation is unnecessary or burdensome. Over the years, the regulators have made numerous claims that banks will soon be offering low-cost accounts[5] and the banks have made similar unsubstantiated claims that they already do. PIRG's bank studies have found little evidence that any significant number of banks offer lifeline accounts.

Only two states, New Jersey (1991) and New York (1994), require low-cost affordable lifeline bank accounts. As the preemption section below discusses, were it not for abusive OCC preemption policies, other states may have copied these important laws. The New Jersey and New York laws are modeled after various proposals championed by Senator Howard Metzenbaum and others throughout the 1980s and early 1990s. The bills require all banks to offer a low-cost account that provides approximately 8-10 checks or debits each month at a fee not to exceed $3/month. This fee structure is adequate to cover banks' reasonable costs, without gouging consumers, although we would be prefer that fees be lower in any federal regulation. Restrictive opening balance requirements are prohibited. Neither state law requires any certification of need.

In 1998, HR 10 passed the House including language requiring banks to offer lifeline accounts. That language was not and is not controversial. In questions-and-answers before this Committee, the provision's author, Rep. Maxine Waters, asked bank witnesses whether they supported lifeline banking, and those that were knowledgeable to respond gave answers such as these by Paul Polking, Nationsbank General Counsel: "We at Nationsbank have always supported HR 10, as you know, and included the lifeline banking provision" or of Stephen Bennett, General Counsel, Banc One, "We have supported HR 10, Representative Waters, and we have understood that support to extend to the lifeline banking amendment."[6] In addition, Citibank strongly supported HR 10, as passed by the House, which included the lifeline provision.

Regardless, the sponsors of HR 10 in 1999 have listened only to the demands of the powerful American Bankers Association and the Independent Bankers Association that the one and only provision in this bill that shows that the Congress cares about all Americans, be deleted. Instead of listening to the ABA, we urge you to listen to the not so powerful 12 million families standing outside the bank, waiting because they cannot afford to get in. If banks want to take advantage of the provisions of HR 10, they shouldn't be allowed to take advantage of average Americans.

(2) PROTECT PRIVACY: Provisions Protecting Consumers From Privacy Invasions Caused By Unfair And Unreasonable Personal Information Sharing By Holding Company Affiliates Must Be Added To The Bill.

While U.S. PIRG has been encouraged that numerous recent stories have documented the problems inherent in information sharing between and among the affiliates of large bank holding companies, no provision of HR 10 would strengthen too pliant laws that allow too much information sharing with too little consumer protection. Although Rep. Ed Markey attempted to add amendments in both the Commerce committee and on the House floor that would have improved the situation, no changes were made.

As enacted in 1970, the Fair Credit Reporting Act (15 USC 1681) included an exception from the definition of credit report for so-called "experience information." The exception's intent was to allow a merchant or employer to provide a reference without triggering the duties of a credit bureau. That section has been abused by debt collectors, that falsely claim to be reporting on their own experience with a debtor only. In our view, it can also be exploited by large financial institutions, which could use the exception to establish unregulated credit bureaus.

In 1996, at the behest of large financial holding companies and despite the vigorous opposition of both the Federal Trade Commission and consumer groups, Congress expanded the experience loophole to allow so-called "affiliate sharing." (FCRA Section 603(d)(2)(A)(ii) and (iii)). Under this provision, once a financial holding company affiliate has obtained a credit report it can share that credit report (as well as any other information from experience or the consumer's application) with any other affiliate under common corporate control, without triggering the consumer protection provisions of the Fair Credit Reporting Act. The proposal established a meager opt-out provision, which has been criticized even by the OCC.

Recently, Acting Comptroller of the Currency Julie Williams added her important voice to those calling for reform. In a May 1998 speech, she admonished bank officials to improve privacy controls and improve disclosures to consumers of their rights to opt-out of this controversial "affiliate sharing exception" to the Fair Credit Reporting Act:

> "In the affiliate information-sharing area, an institution that wants to share information with a related company may do so free of restrictions placed on credit bureaus, provided that the consumer receives advance notice and opportunity to direct that the information not be shared. In other words, consumers have the right to "opt out" of any information-sharing arrangements.
>
> But, unfortunately, it has been known to happen that the affiliate-sharing "opt out" disclosure is buried in the middle or near the end of a multi-page account agreement. For existing accounts, some institutions have gotten into the habit of reducing the required "opt out" disclosures to the fine print along with a long list of other required disclosures. Few consumers are likely to have the fortitude to wade through this mass of legal verbiage, and fewer still will take the time to write the required "opt out" letter. I have even heard of people getting two separate notifications covering different types of information, requiring two separate letters to opt out. Such techniques may fall within the letter of the law, but they certainly fall short of its spirit."[7]

On 12 June 98, Williams announced formation of a new privacy working group: "Financial privacy is one of the most important issues facing the public today. I intend to do everything possible to make sure that our nation's banks emerge as leaders in efforts to protect consumer privacy."

In PIRG's view, strengthening the opt-out is a modest first step. It does not, however, go far enough. We do not think a health insurance subsidiary should be able to share confidential data with a credit card subsidiary. We don't think that consumer experience information -- bank account balances, types of accounts owned -- should be shared with affiliates or third-parties. As the Federal Trade Commission has recently pointed out, more needs to be done.

> "Cross-industry mergers, such as the Citicorp/Travelers Group transaction, may raise important privacy concerns, in particular over the treatment of consumer information by affiliated companies. Such mergers may allow detailed and sometimes sensitive information about consumers, including medical and financial data, to be shared with relatively few restrictions among newly related corporate entities. Consumers might not anticipate that providing information to one entity for insurance underwriting purposes, for example, might later be used for different purposes by a financial institution that is or becomes an affiliate.[8]"

It would not be an overstatement to say that, of all the compromises consumer groups were forced to agree to in the long battle to amend the FCRA, the establishment of the affiliate sharing exception is the one that concerned us the most, since it rolled back consumer privacy rights, failed to establish offsetting privacy protections, and posed the greatest risk of unknown (to Congress anyway, but perhaps not to its proponents) consequences.

If the committee goes forward with HR 10, it must eliminate or at least narrow the "experience information" and "affiliate sharing" exceptions to the Fair Credit Reporting Act, strengthen consumer disclosures for remaining information sharing, if any, and change the unacceptable opt-out provision to an opt-in. While we welcome the spotlight on privacy that your hearings, Chairman Leach, on information brokers have provided, we believe a more comprehensive solution is required. We are working with Rep. LaFalce, Rep. Markey, Sen. Sarbanes and others on broader solutions to the information sharing problem and we would be happy to work with you on amendments to HR 10 before the markup.

(3) STRENGTHEN GUARANTEE THAT STATE CONSUMER PROTECTION LAWS ARE NOT PREEMPTED:

The 1999 version of H.R. 10 incorporates a long, tortured preemption provision designed to codify the Supreme Court's controversial Barnett standard bank insurance sales. While we appreciate the complexity of the problem the committee is trying to solve in the insurance area, we believe that HR 10's preemption provision fails to clearly state that existing and future state consumer protection laws are protected. In fact, various parts of the preemption standard could be viewed as further restricting state authority in other areas.

Since HR 10 is intended to represent the most up-to-date views of the Congress on financial regulation, it is incumbent upon you to add a savings clause that describes and codifies the ongoing authority of the states to protect their consumers from unfair and deceptive financial practices.

Additional language should be inserted based on the preemption analysis in the Riegle-Neal conference report discussed below.

OCC preemption determinations have not only restricted the applicability of laws passed by states, but have had a chilling effect on state consideration of other proposals. Bank lobbyists use a tag team approach to defeat, weaken or delay pro-consumer proposals. National bank lobbyists tell state legislators that bills will not apply to them; then, state bank lobbyists claim that bills will create an "unlevel playing field." The result: most bills do not pass.

Preemption has had a chilling effect on consideration of legislation to ban the double-dipping ATM surcharge. A recent PIRG survey found that more than half the states are currently considering ATM surcharge bans, yet none have been enacted.[9]

In Massachusetts, for example, an ATM surcharge ban bill has passed the Senate unanimously, and has a plurality of co-sponsors in the House, yet bank lobbyists have boxed it in. In addition, in Massachusetts, a new law capping certain Deposit Item Return (DIR) fees was narrowed to only apply to state-chartered banks, despite the absence of any federal legislation capping these onerous fees imposed on the unknowing victim-recipients of others' checks that bounce.[10] The narrowing of the bill was directly tied to the overt threat of OCC preemption.

Under the current regulatory environment, the states are afraid that the OCC will abuse its preemption authority. Consequently, Mr. Chairman, the states are prohibited by an unelected regulator from exercising their traditional role as the "laboratories of democracy," and everyone suffers, as neither the states, nor the Congress, enact pro-consumer legislation.

Over the last ten years, the OCC, at the behest of banking institutions, has sought to override the long-standing right of the several states to enact stronger consumer protection laws, even in the absence of concomitant federal legislation. While the Congress itself has abused preemption, such as in the 1996 Fair Credit Reporting Act amendments[11], it has also made modest attempts to rein in the OCC. In 1994, the Conference Report of the Reigle-Neal Interstate Branching Efficiency Act stated that the Congress found the OCC had gone too far, especially when it preempted the New Jersey Checking Account law of 1991.[12]

> Generally, State law applies to national banks unless the state law is in direct conflict with the Federal law, Federal Law is so comprehensive as to evidence the Congressional intent to occupy a given field, or the State law stands as an obstacle to the accomplishment of full purposes and objectives of the federal law...
>
> ...the Conferees have been made aware of certain circumstances in which the federal banking agencies have applied traditional preemption principles in a manner in which the Conferees believe is inappropriately aggressive, resulting in preemption of state law in situations where the federal interest did not warrant that result. One illustrations is OCC Interpretative Letter #572, dated January 15, 1992, from the OCC to Robert M. Jaworski, Assistant Commissioner, New Jersey Department of Banking...In the case of Interpretive Letter #572, it is the sense of the Conferees that the fact that the Congress has acknowledged the benefits of more widespread use of lifeline accounts through the Bank Enterprise Act <u>did not indicate that Congress intended to override State basic banking laws, or occupy the area of basic banking</u>

services to such an extent as to displace State laws, or that the existence of State basis banking laws frustrated the purpose of Congress.[13] (emphasis added).

Since New Jersey enacted its legislation, only New York has followed with additional lifeline rules. Riegle-Neal also statutorily required the OCC to begin to subject preemption determinations to a form of administrative notice and comment. When the New Jersey Banking Commissioner submitted a petition, which has yet to be acted on by the OCC, the agency admitted that no federal law requires lifeline banking.

> "the BEA [Bank Enterprise Act] does not, however, require depository institutions to offer these lifeline accounts; that decision is left to individual depository institutions." (emphasis added)[14].

Recognizing the agency's recalcitrance on the critical matter of state consumer protection rules, when the Congress amended Riegle-Neal in 1997, it even called for an annual report analyzing the agency's abuses of preemption.[15]

In analyzing the problems that HR 10's sweeping preemption language will create, it is important to note that the Congress has not adequately regulated in numerous areas -- such as lifeline banking and ATM surcharge rules. No federal law explicitly requires banks to provide lifeline banking accounts. Conversely, no regulatory policy of either the OCC, the FDIC or the Federal Reserve Board or any other agency explicitly requires financial institutions to provide any account or service in conflict with the New Jersey Checking Account law. In the absence of conflicting federal law, it has long been the federal tradition of this country that the states proceed to protect their consumers, as New Jersey and New York have correctly done. Over 700,000 New Jersey consumers have obtained New Jersey Checking Accounts.[16] Other states should have followed this successful lead, but were restrained by the inappropriate actions of an unelected regulator. The Comptroller of the Currency should be reined in. HR 10, instead, would throw off the reins altogether.

Recently, instead of adhering to the clear Congressional mandate of Riegle-Neal, the OCC has in fact stepped up its attacks on state authority. The agency has intervened in state court in support of Fleet Bank, seeking to overturn Connecticut's ban on ATM surcharges. You may be interested to know, Mr. Chairman, that in 1998 the agency has also filed an amicus brief in challenging Iowa's ATM surcharge ban in federal court.[17] The OCC's actions on preemption appear to be more those of an indentured servant of the industry than of a regulator concerned with the will of the Congress.

(4) SUITABILITY REQUIREMENTS MUST BE REINSTATED: The 1998 Bill's Consumer Protections When Uninsured Investment Or Insurance Products Are Offered To Consumers Must Be Maintained

One of the few victories on behalf of consumers on the House floor last year was the acceptance of strengthening amendments ensuring that consumers gain protection from unfair insurance and securities sales practices. Numerous studies by the FDIC, AARP, the National Association of State Securities Administrators, Consumers Union, and other groups have documented the need for strong consumer protections when banks sell both insured and uninsured products. Recently, Nationsbank agreed to a civil penalty totaling $6.75 million for allegedly misleading some 13,000 unsophisticated, elderly investors who were sold complex derivative-based securities instruments. Nationsbank had previously settled a class action case for $40 million by former customers.[18] These

are clearly unsuitable products, yet HR 10 as introduced no longer includes tough unsuitability rules.

U.S. PIRG concurs with the detailed analysis of Consumers Union in their testimony today regarding the need for these consumer protections. When banks function as one-stop supermarkets, they have tremendous power over consumers. Consumers must be guaranteed that products will be marketed fairly, with no tying, and with full disclosure. Consumers must also have the same rights of redress when they purchase a product from a bank as when they do so from an insurance agent or a brokerage.

(5) DELETE INSURANCE REDOMESTICATION GIVEAWAY: Provisions Allowing Companies Undergoing Mutual-To-Stock Insurance Conversions (Redomestication) Without Consumer Protections Must Be Eliminated

While the committee leadership chose, in its wisdom, to delete lifeline banking, the only public interest provision of HR 10 as passed by the House, it also chose to re-insert one of the most egregious special interest giveaways that had previously been deleted. Provisions of HR 10 on mutual insurance stock conversions could precipitate a race to the bottom, as companies forum-shop for states with no consumer protections, convert, and then fail to compensate mutual policyholders. While HR 10 contains some modest consumer protections, they do not go far enough. The amounts of money at stake are staggering. In New Jersey, a Prudential conversion could transfer assets worth $20 billion.[19] Total insurance assets under consideration for conversion are now approximately $50 billion[20]. Laws must guarantee that policy holders receive adequate compensation. According to a Center for Insurance Research analysis of a report by the New York State legislature on necessary consumer protections in mutual to stock conversions, the following are necessary conditions:

-- requiring "real, tangible compensation" to policyholders in an MHC conversion,
-- providing a means for policyholders to share in the future profitability of the MHC entities,
-- tightening limits on executive compensation in stocks and options,
-- forbidding management to waive dividends to the MHC,
-- limiting the sale to outsiders of all types of stock, not just voting stock,
-- requiring a majority of all policyholders eligible to vote to approve a plan to convert,
-- mandating that a MHC conversion be approved only if it is in the "best interests" of policyholders,
-- requiring SEC-type disclosure to policyholders of all the risks of the proposed conversion
-- requiring insurers to set aside funds to ensure that policyholders have adequate means to communicate with each other before a vote on the conversion,
-- abolishing the requirement that a bond be posted before a court challenge to a conversion.[21]

In U.S. PIRG's view, the provisions of HR 10 pertaining to mutual-to-stock conversions should be reviewed based on these findings. Sections 311-316 should be eliminated from the bill or substantially modified to meet these conditions before the bill goes forward.

Conclusion

Thank you for the opportunity to present our views today. Properly constructed, financial modernization offers opportunities for consumers and financial institutions. It is the responsibility

of the Congress to ensure that any final bill maintains the safety and soundness of our financial system, and protects consumers and communities, as well as modernizes the structure of the industry. We look forward to working with you.

Footnotes:

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[1] See for example a 1996 report by Stephen Brobeck, Consumer Federation of America, "Bank Mergers and the Consumer Interest." See also, testimony of William McQuillan, Independent Bankers Association of America or of Professor James Brock of Miami University (OH), both before the House Judiciary Committee, 3 June 1998.

[2] A 1988 GAO report, "Government Check Cashing," probably more accurately placed the estimate at 18 million families. We doubt that there has been such improvement.

[3] See "Big Banks, Bigger Fees," U.S. PIRG, 31 July 1997 (http://www.pirg.org/consumer> or see "Annual Report to Congress of Fees and Services of Depository Institutions," Federal Reserve Board, June 1997, <http://www.bog.frb.fed.us/boarddocs/RptCongress/feesIndex.htm>. The U.S. PIRG study compares fees at the nations' 300 largest banks (which hold 2/3rds of all deposits) to those at other banks and documents a widening 15% fee gap between large and small institutions. The fed compares fees at single state and multi-state institutions, finding that multi-state institutions, which are larger, charge higher fees.

[4] For an excellent analysis with recommendations for action, see Hudson, Michael, "Predatory Financial Practices: How Can Consumers Be Protected?" AARP, Winter 1998.

[5] See, for example, the OCC's 1997 polemic, "Financial Access in the 21st Century," or former Comptroller Ludwig's 12 Jan 98 address to a Los Angeles forum convened by Rep. Maxine Waters, author of HR 10's lifeline provisions, for typical agency analysis: "Despite the numerous accomplishments of U.S. depository institutions to date, we know that millions of American households do not have deposit accounts. What we do not know well is why..." (Ludwig, at 25).

[6] Transcript of hearing of House Banking Committee on Financial Mergers, 29 April 1998, pages 238-240.

[7] Remarks by Julie L. Williams, Acting Comptroller of the Currency before the Banking Roundtable Lawyers Council, May 8, 1998, <http://www.occ.treas.gov/ftp/release/98-50a.txt>

[8] Testimony of William Baer, Director, Bureau of Consumer Protection, Federal Trade Commission, before the House Judiciary Committee, 3 June 1998, Hearing On Bank Mergers.

[9] Connecticut and Iowa Banking Commissioners have imposed administrative bans.

[10] Massachusetts DIR legislation took effect in February 1998, (St. 1997, c. 178) amending MA. GL c. 167D Sec 3 and c. 171, Sec 41a.

[11] Comprehensive 1996 amendments to the Fair Credit Reporting Act, 15 USC 1681 et seq., could have been enacted in 1992, were it not for the financial industry's demand that all state laws in the area be overturned. Under the 1996 compromise, the state laws pertaining to pre-screening, notices, obsolescence and timetables, which arguably are of interstate import, were preempted, but so were all provisions pertaining to regulation of banks. However, these provisions all sunset eight years after enactment.

[12] 15 Jan 92 letter (Interpretative Letter #572) of OCC General Counsel William Bowden preempting New Jersey's Proposed Regulation 1991-620.

[13] Pgs. 53-54, Report No. 103-651, U.S. House of Representatives, 2 August 1994.

[14] 4516 FR Vol 61#25, 6 Feb 96

[15] Public Law 105-24 enacting HR 1306, Section 2(b).

[16] Testimony of New Jersey Banking Commissioner John M. Traier before the NJ Assembly Committee on Financial Institutions, 4 March 1996, at 6.

[17] See, for example, Bank One vs. Michael Guttau, Iowa Banking Superintendent (Civil NO. 4-98-CV-10247. Also see Fleet Bank Vs John Burke, Banking Commissioner of the State of Connecticut, CV-98-584565. In the OCC's amicus in the Connecticut case, OCC incredibly asserts that the National Bank Act's visitation provisions are controlling over the clear provisions of Riegle-Neal noted above and over the Electronic Funds Transfer Act's explicit anti-preemption authority.

[18] See "Nationsbank To Pay $6.75 Million In Fines," Marcy Gordon, the Associated Press, 4 May 1998.

[19] See Joseph Treaster, "New Laws Could Shortchange Prudential Policyholders," the New York Times, 18 June 1998 for a discussion of consumer advocate concerns over a new law governing a Prudential conversion.

[20] See "Insurance Giants May Go Public", Associated Press, AP On-Line, June 21, 1998.

[21] See press release of Center for Insurance Research, April 29, 1998, "NEW YORK ASSEMBLY INSURANCE COMMITTEE BLASTS MUTUAL HOLDING COMPANY CONCEPT." Also see letter of CIR and other groups to Rep. John LaFalce criticizing HR 10's conversion language, 12 May 1998.

Public Interest Research Groups
State PIRG Financial Services Priorities 1999

The state PIRGs believe that Congressional proposals such as HR 10 (financial modernization) are unbalanced and unfair unless they also modernize consumer and customer protections. These are highlights from our detailed reform platform. **Contact Ed Mierzwinski, Consumer Program Director (202-546-9707 ed@pirg.org or write State PIRGS, 218 D St SE, Washington, DC 20003) for the full platform.**

(1) Financial Modernization (HR 10) Must Require Affordable Basic Banking Services
Despite record bank profits, over 12 million families don't have bank accounts, according to Treasury data. An additional 48 million families can nominally afford bank accounts, but maintain average balances of less than $1,000 and pay the brunt of the rising bank fee burden. PIRG and Federal Reserve Board studies have documented conclusively that big banks charge bigger fees, instead of passing along lower costs from economies of scale. **Last year, HR 10 passed the House with a modest Waters provision requiring affordable lifeline accounts. Unfortunately, the Senate Banking Committee deleted it and Chairman Leach has disappointedly deleted it from the 1999 version of HR 10, as introduced.**

(2) Retain Amendments Guaranteeing That Financial Modernization Proposals Provide Customer Protection From Unfair Sales Practices, Including Anti-Tying And Suitability
In 1998, amendments offered by Reps. Dingell and LaFalce guaranteed that financial services consumers would not face unfair sales practices of uninsured products.

(3) Upgrade Financial Laws To Guarantee That Banks And Other Firms Use Fair Information Practices To Protect Consumer Privacy
Adequate financial and medical privacy laws do not exist in the United States. A Congressionally-approved loophole in the Fair Credit Reporting Act (FCRA) allows bank holding companies to share confidential records with their affiliates without concomitant privacy protection. **Financial modernization proposals must include bills such as S. 187 (Sarbanes) to guarantee privacy protection. The affiliate sharing loophole must be closed. Consumer liability protection should be added to the Sarbanes bill.**

(4) Stop Unfair And Anti-Competitive Bank Fees, Especially ATM Surcharges
Charging consumers twice for one transaction is unfair, but surcharging is worse than that. Surcharging also anti-competitively benefits higher fee bigger banks. So, it affects all consumers, not only those who "choose" to pay, or avoid, them, since it allows big banks to unfairly pirate customers from low-cost community banks. Ultimately, surcharges will lead to higher fees for everyone and less consumer choice. **PIRG supports legislation, such as proposals offered in 1998 by Sens. D'Amato, Kerry, Boxer and others, and by Rep. Sanders, to ban unfair and anti-competitive ATM surcharges.**

(5) Protect Consumers From Unfair Credit Card And Debit Card Practices:
Last year the only bright spot in Congressional consideration of outrageous, special interest-driven bankruptcy legislation was the Senate's passage of critical consumer protection amendments:

-- The Senate approved a Reed (RI) amendment limiting debit card liability to $50 by law, the same as credit cards, since consumers could lose all the money from their checking accounts without, for example, either giving away their PIN numbers or losing their cards. (Section 208 of HR 3150)

-- Credit card company marketing (Sec 209, HR 3150) and billing practices must be reined in: For example, the Senate also approved a Reed amendment requiring credit card billing statements to disclose how many months a consumer would need to pay off a credit card balance, making the minimum payment.

(6) Protect Consumers, Not The Fringe Banking Industry, From Predatory Practices
Subprime lenders, payday loan stores, rent-to-own companies and other predatory lenders are gouging consumers with high prices for auto, second mortgage and small payday and auto title loans, as well as offering high-priced check cashing services. Congress must protect their customers from unfair practices. Unfortunately, some purported reforms, such as one rent-to-own bill, HR 2019 (Jones, 105th), would actually legalize the fringe banking industry's deceptive practices and are unacceptable.

(7) Stop the Office of the Comptroller of the Currency's (OCC) Assault on Federalism:
The Congress must also enforce its 1994 guarantee in the Riegle Neal Interstate Branching Act that the states retain their clear rights to enforce consumer protection laws, against an abusive OCC assault on federalism, which has had a chilling effect on consideration of state legislative reforms.

TESTIMONY OF RALPH NADER

COMMITTEE ON BANKING AND FINANCIAL SERVICES

U. S. HOUSE OF REPRESENTATIVES

February 11, 1999

Mr. Chairman, members of the House Banking Committee, thank you for the invitation to comment on HR 10.

These hearings mark the third consecutive Congress in which financial deregulation has dominated the agenda of this Committee. Thousands of hours of the time of Members of Congress and their staffs have been expended in a futile effort to craft a bill that will be embraced by the maximum number of corporate lobbyists.

Unfortunately, little of this time and legislative labor have been used for a broad detailed examination of the issues which affect the safety and soundness of our financial system and the needs and desires of citizens who will use the system. Little time and few resources of the Congress have been allocated to devise a rational and modern regulatory system which protects the taxpayers and ensures the delivery of financial services to *all* citizens on a nondiscriminatory basis.

HR 10 is not a bill for consumers. It is a bill designed to create new profit centers for a relative handful of banking and financial services corporations--corporations that will form combinations which will dominate the delivery of financial products and fuel the already alarming trend toward mega mergers and the concentration of economic power.

Apparently the sponsors of HR 10, themselves, have major questions about where this legislation will lead and what problems may emerge when banks, securities firms, insurance companies merge under common ownership. Section 186, for example, requires the Federal Deposit Insurance Corporation (FDIC) to conduct a study of how these mergers will affect the safety and soundness of the taxpayer supported deposit insurance funds. Elsewhere in the bill, the General Accounting Office is instructed to determine the impact of HR 10 on community banks and consumers, again only after the legislation is enacted..

These are critically important questions that go to very heart of the bill. These are areas where the Committee needs to determine the facts *before* HR 10 becomes law.

What happens if the FDIC and the GAO do, indeed, find serious defects, problems that could seriously jeopardize the health of the financial system? Does anyone believe that major remedial action will be possible against the opposition of the combined lobbying forces of the financial industry--the political power of conglomerates that will reach into virtually every Congressional district across the nation.

The opportunities for change will be few. Congress needs to get it right now, not after the fact. At the moment, the leaders of the various segments of the financial community want something from Congress. While the corporations have their hands out, Congress is in a position to insist on protections for consumers and communities. That leverage will disappear the moment that the President signs HR 10 into law.

Instead of dealing with issues involving safety and soundness and the economic well being of consumers and communities, most of the effort has centered on mediating the differences between competing industry groups, all of which want deregulation on their own terms. As a result, the current version of HR 10 is a patchwork of inter-industry compromises that fall far short of meeting the sponsors' self-serving claim that they are "modernizing" the financial system.

HR 10 is designed to create a financial system for the more affluent in our society. In the financial world envisioned under HR 10, the needs of middle and low-income consumers have been largely ignored or shunted aside in the rush to accommodate the high rollers.

Don't be taken in by industry and political propaganda that financial deregulation--or "modernization" as its proponents prefer--is consumer friendly. The legislation does contain some important disclosure requirements regarding uninsured products, but for the vast majority of citizens, the mega conglomerates created by HR 10 will only add new hurdles to the already nightmarish task of obtaining basic financial services without incurring outlandish and arbitrary fees and being sent off to the wasteland of endless 1-800 numbers and pricey automatic teller machines.

What consumers can expect from conglomerates created by HR 10 is more of the kind of "service" that is currently being ladled out by banks like First Union Corporation of North Carolina which has gobbled up smaller banks up and down the east coast. First Union, under the guidance of its chairman, Ed Crutchfield, provides service on the basis of how much profit each customer provides the bank.

First Union, the *Wall Street Journal* reports, monitors each account, color codes the account in the bank's computer system. When a customer calls, the computer designates the profitability by showing a small block of color next to the customer's name-- green for highly profitable; yellow for so-so profitability and red for customers who don't do all that much for the bank's bottom-line. As might be expected, the bank personnel leap to attention in handling calls from the customers with the "green" block by their names. But, as the *Journal* notes, the bank employees "rarely budge" for a call from a less profitable customer--one where a red block pops up beside the name.

ONE-STOP SHOPPING CENTERS AND CONSUMER PRIVACY

Proponents have tried to sell HR 10 by promoting the concept of "one-stop shopping centers" where consumers can play the stock market, be sold insurance products and have access to a variety of banking products. So far, the industry has failed to produce any evidence that consumers are beating on their doors, demanding that all these services be bundled under one roof and under one corporate umbrella.

What we hear from consumers are not demands for one-stop financial shopping centers, but a steady stream of wide ranging complaints about the deteriorating quality of service provided by financial institutions--and the failure of Congress to halt the rising wave of arbitrary fees imposed on customers--fees which last year totaled more than $18 billion. .

The idea of these corporations extending their reach--and their unconscionable fees-- through one-stop shopping centers does not thrill consumers. The propaganda in support of HR 10 hides the realities of the marketplace where "captive customers" will be trapped in unwanted and anti-competitive cross-marketing schemes generated among the multitude of financial affiliates that will be created by this legislation--accompanied by a wholesale invasion of personal privacy.

The financial conglomerates created by HR 10 will have an unprecedented amount of the most sensitive information about consumers including account balances, CD maturity dates, sources of deposits, medical histories and detailed data on the assets of individuals.

Not only can this information be shared among the affiliates, but the data can be sold to third parties such as a direct marketer, another financial institution or an Internet web site without notifying the customer that the information is being shared or obtaining the customer's consent.

At a minimum, HR 10 should provide that no information be shared with either affiliates or third parties unless the consumer gives contemporaneous approval in writing --a specific "opt-in" by the consumer. Industry-promoted "opt-out" schemes are inadequate to protect privacy rights. Under "opt-out" corporations are free to share the information unless the consumer has affirmatively objected.

In obtaining written permission for release of the information, the institutions should be required to inform the customer what information is to be disclosed and when and to whom for what purposes. In addition, the consumer, before signing a release, should be given an opportunity to review the information to ensure its accuracy.

Some industry lobbyists are quietly passing the word that an "opt-in" protection for privacy will be a "poison pill" for the legislation. If this proves to be the case, this will provide an interesting test for the Committee--will the Members vote to protect the privacy of their constituents or will they support the industry's demand for a free wheeling use of confidential information for profit-making cross-marketing purposes?

SAFETY AND SOUNDNESS AND TAXPAYER RIGHTS

This Committee played a commendable role in cleaning up the costly savings and loan debacle, albeit with a massive bailout provision.. Chairman Leach, you and Henry Gonzalez formed a strong team that not only pushed most of the rascals out of the industry, but led the way to reforms which were essential to restoring the confidence of the American people in our financial system.

Most of the Members of the present Committee, of course, were not in office when the financial reform legislation was adopted in 1989 and 1991 in the wake of the huge failures in both the savings and loan and banking industries.

Mr. Chairman, I think you will agree that there was an implicit promise to the American people from this Committee, the entire Congress and then-President Bush that new risks would not be added to deposit insurance and the federal safety net without commensurate strengthening of regulation.

HR 10 does not keep that promise.

Rather than strengthening and rationalizing the disjointed and overlapping financial regulatory system, the legislation makes the system worse by scattering regulation, not only among six federal agencies, but among agencies in the 50 states, the District of Columbia and Puerto Rico--all under the excuse of preserving "functional" regulation--as if that was some regulatory holy writ.

Regulators, banking officials, financial analysts, key Members of Congress and the General Accounting Office have often pointed to the inefficiencies, conflicting interpretations of regulation, and the lack of accountability created by the current system. Through the years, bills have been introduced to create a single coordinated agency that would have the sole responsibility of regulation,. The legislation has failed in the face of opposition from the different segments of the financial community, each wanting to keep its own familiar agency. The agencies, in turn, have resisted any legislation which might endanger their share of the regulatory turf. This combination has so far been able to stymy change.

In 1994, Comptroller of the Currency Eugene Ludwig, in a burst of candor, told the Congress "it is never entirely clear which agency is responsible for problems created by faulty, or overly burdensome, or late regulation.'

The former head of the General Accounting Office--Charles Bowsher--frequently pled with Congress to change and coordinate the system. In 1993, he told this Committee:

"The current regulatory structure has evolved over more than 60 years as a patchwork of regulators and regulations...we question the ability of the current regulatory structure to effectively function in today's complex banking and thrift environment. We believe the House and Senate Banking Committees, in

conjunction, with the Administration, should assess the appropriateness of continuing with the present regulatory structure and develop viable alternatives to that structure.

That was six years ago and before Congress contemplated the current legislation to greatly expand the responsibilities of the regulatory agencies by combining banks, insurance companies, securities firms and, in some cases, non-financial corporations under common ownership. If Comptroller General Bowsher questioned the efficacy of the system in 1993, what would he say about the same system if Congress goes through with its plan to pile on the vast new responsibilities of HR 10?

Like so much of the bill, the Rube Goldberg regulatory structure of HR 10 is the result of a patchwork of compromises adopted in meeting industry demands and resolving the different industry perspectives of the shared jurisdiction of this Committee and the House Commerce Committee.

Mr. Chairman, I have no illusions about the degree of difficulty of reworking, strengthening and coordinating the financial regulatory system. It would be tough. But, you have decided to make a monumental change in the landscape of the nation's financial system. If the upheaval in financial structure is the high priority that you have assigned it, then it follows that the same priority must be applied to changing the regulatory structure.

Modernizing one without modernizing the other is a recipe for financial disaster and an invitation to another round of taxpayer bailouts. I know that reforming the regulatory system would create turmoil for this Committee and the Congress. But, surely that turmoil is infinitely preferable to the turmoil of a failed regulatory system.

Mr. Chairman, it is an open secret that this legislation is creating a new generation of "too big to be allowed to fail" institutions. If this Committee and the Congress fail to set up a strong and rational regulatory system, the taxpayers will be left to pick up enormous tabs for bailouts--bailouts that will make the savings and loan collapse look small. It would be shameful for this Committee to provide for trillion dollar conglomerates and leave taxpayers protected by the current rickety, overlapping and inadequate regulatory apparatus.

WHY THE SPECIAL TREATMENT FOR INSURANCE COMPANIES?

Insurance companies receive special treatment under HR 10, testimony to their immense financial and lobbying clout These companies will be allowed to become federal financial services holding companies without facing federal safety and soundness regulation.

They will continue to be regulated by insurance departments in the 50 states--insurance departments that, for the most part, are woefully underfunded, understaffed and overly dependent on the companies they regulate. Not only will these companies avoid federal safety and soundness examination, but they will also escape CRA-like community

responsibilities and will not be required to report where they make investments and sell policies as commercial banks are required to report where they make loans under the Home Mortgage Disclosure Act (HMDA).

As is true in the recent Travelers Group-Citicorp merger, insurance companies will be the dominant corporate entity in many of the holding companies. Should they fall on bad times or fail, these insurance companies would have the potential to drag down the entire holding company including banks guaranteed by taxpayer-backed insurance funds. The federal safety net--but not federal regulation--will be extended directly and indirectly to these insurance affiliates.

Federal regulators would be subservient to state insurance departments. Except under extraordinary circumstances, federal regulators would be required to defer to the state regulators on examinations, capital requirements as well as interpretations and enforcement of regulations.

In 1990, during a period of rising insurance company failures, the House Commerce Committee found "numerous weaknesses and breakdowns in this (state) system, including lack of coordination and cooperation, infrequent examinations based on outdated information, insufficient capital requirements and licensing procedures, failure to require use of actuaries, incomplete audits and improper influence on regulators.

Last year, the Wall Street Journal used the state of Indiana as an example in a story on lax state insurance regulation. In Indiana, the Journal reported, financial examiners--accountants who verify the financial soundness of the companies--make at most $31,980 yearly. The division assigned to investigate consumer complaints has no investigators on its staff, only "consumer consultants" who told the Journal that they do little more than forward complaints to companies. The department does not have a single actuary on staff to examine the fairness of insurance rates.

Even in the handful of states where insurance departments are reasonably funded and staffed, the emergence of hundreds of companies that do business across state lines as well as overseas makes it impossible for a single state department to monitor and assess risks. Adding to the difficulty is the growing complexity of investments engaged in by these companies.

The insurance industry has resisted successfully attempts to extend anti-redlining requirements to insurance companies--provisions that would require the companies to report by census tract where they write policies and make investments. They blocked federal anti-redlining legislation in 1993. Similarly, big insurance companies in 1996 maneuvered behind the scenes to scuttle a proposal of the National Association of Insurance Commissioners to conduct an industry-wide study of redlining.

Not only does HR 10 fail to extend anti-redlining provisions to insurance companies, but it makes it easier for the mutual insurance companies to rip off mutual policy holders--the true owners of the mutual companies. To facilitate this quick grab of the assets of policy holders, the legislation preempts state laws so mutual companies can change their domicile to states with laxer laws governing the rights of consumers when a

company converts to stock ownership, At stake are tens of billions of dollars worth of assets that belong to the policy holders.

Sound regulatory policy that protects not only the safety and soundness of holding companies, but access to insurance by citizens and small businesses in all neighborhoods should not be sacrificed to the powerful insurance lobby. Insurance companies want this legislation badly. They should be willing to meet minimum regulatory standards--and the Committee should insist that they do.

THE DANGERS OF THE FEDERAL RESERVE AS LEAD REGULATOR

Faced with the dilemma of a disjointed regulatory system and lacking the courage to restructure the system, HR 10 tilts heavily toward anointing the Federal Reserve System as regulatory czar. More power for the Federal Reserve is not the answer.

Supporters of HR 10--and the media--often hang their arguments for deregulation on what they describe as an urgent need to wipe out "depression-era" laws--as if the mere date of these laws was enough rationale for a wholesale wipe out.

If the proponents are worried about what they describe as "outdated" statutes they might take a look at the Federal Reserve Act of 1913. It is doubtful that such a law, riddled with built in conflicts of the interest, lack of accountability and CIA-like secrecy would be taken seriously today as a proper framework for a federal regulatory agency.

Just as it was enacted in 1913, the Federal Reserve Act allows commercial banks to select two thirds of the board of directors of each of the 12 Federal Reserve Banks. As a result, not only are bankers on these boards, but representatives of corporations including securities firms and insurance companies. Among the functions of these Federal Reserve Banks are examinations and supervision of holding companies and state chartered banks that are members of the Federal Reserve.

The Federal Reserve Board also faces frequent conflicts between its primary role as the monetary policy czar and its role as a bank regulator. Hard-nosed regulatory decisions that protect the safety and soundness of banks and the taxpayer-supported deposit insurance funds do not always coincide with a central bank's concept of what promotes its desires on monetary and economic policy at any given moment.

Last fall's near collapse of the big hedge fund--Long Term Capital Management--is an example. The Federal Reserve--led by Chairman Alan Greenspan and President William McDonough of the New York Federal Reserve Bank--engineered a $3.5 billion corporate bailout of the hedge fund, claiming that there was danger of a "market meltdown." In the process, the Fed leaned on three big commercial banks under its day to day supervision--Bankers Trust, J. P. Morgan and Chase--to put up $300 million each for the bailout.

It takes no great analysis to realize that the Federal Reserve was pushing for the bailout money to assist its self-perceived role as economic czar, not as a bank regulator

that believed the most prudent banking decision was for three federally-insured institutions to cough up nearly a billion dollars in credit to a sick hedge fund.

In an op-ed article in the Washington Post, Chairman Leach wrote:

...it is difficult not to be struck by the fact that shrewdest in the hedge-fund industry could commit such investment errors; that the most sophisticated in banking would give a blank check to others in an industry which they are also considered to be experts; and that the U. S. regulatory system could be so uncoordinated and so easily caught off guard.

In the 1987 stock market downturn, the Federal Reserve was also busy filling potholes in the economy. During this period, Continental Illinois exceeded legal limits on extensions of credit to one of its ailing subsidiaries, First Options. Continental's primary regulatory agency--OCC--cited the violation and ordered the bank to cease and desist in further loans to the subsidiary.

But, the Federal Reserve, agonizing over monetary policy and a major drop in the fortunes of the stock market, decided that its purposes were best served by propping up the affiliate. As a result it let the holding company parent--over which it had regulatory jurisdiction--extend more credit to First Options, effectively negating what the Comptroller had decided was the proper move to enforce safety and soundness regulations.

Conflicts between monetary policy and bank regulatory policy is the reason that many nations separate the two functions. These include Great Britain, Austria, Belgium, Canada, Denmark, Finland, Germany, Japan, Mexico, Norway, Sweden and Switzerland.

Aside from this conflict of roles, the Federal Reserve does not have a sterling record as a banking regulator. A few years ago, the GAO raised a number of questions about the Federal Reserve's performance, noting that "lack of minimum inspection standards has resulted in a superficial approach to the bank holding company inspection process." Superficial examinations of HR 10's huge conglomerates could be disastrous.

And, of course, this is the same Federal Reserve that failed to realize that BCCI, the international rogue bank, had secretly moved into the U. S. banking system--even though BCCI's major takeover was First American Bank, located a short six blocks from the Federal Reserve's offices in Washington, D. C. It was only after the governments of other nation's uncovered BCCI operations did the Federal Reserve realize it had missed the bank's illegal presence in this country.

An expanded role for the Federal Reserve cannot be good news for consumer and community groups.

Dr. Kenneth Thomas of The Wharton School, who has published detailed studies of the federal regulatory agencies, describes the Federal Reserve in this manner:

"The problem is that the Fed almost always takes a pro-banking, rather than a pro-

consumer view on major issues. Perhaps this shouldn't be surprising considering the large number of bankers, bank lawyers and lobbyists who are former Fed employees or, conversely, the large number of Fed Board members (like Alan Greenspan) who are from Wall Street or financial districts instead of Main Street or low and moderate income neighborhoods."

Two years ago, the Federal Reserve severely damaged fair lending initiatives by refusing to adopt regulations that would have allowed the collection of data on race and gender of applicants for consumer and small business loans--something that community and civil rights organizations argue is essential in ferreting out discriminatory patterns and practices and in the enforcement of Equal Credit Opportunity Act.

The Justice Department and the Office of the Comptroller of the Currency pled with the Board to adopt the regulations, but back came a flat "no." How did the Board justify its refusal to help promote fair lending? On the grounds that it didn't have sufficient guidance on national policy on the issue. The Fed doesn't know we have a national policy against discrimination?. Nonsense.

The Federal Reserve should be left with its monetary policy functions. It has not earned a promotion to czar of all in the financial world.

COMMERCE AND BANKING--A VOLATILE MIXTURE

Mr. Chairman, once again I congratulate you for winning the battle against mixing banking and commerce when this legislation was on the floor in the last Congress. You fooled the experts who predicted your efforts were doomed to failure.

But, the issue will be back before this Committee, and the battle will have to be joined again. We also know that Senate Banking Chairman Phil Gramm is planning to introduce a version of HR 10 which includes a significant basket of banking and commerce.

It is ironic that these proposals continue to be promoted after we have so recently witnessed the problems that have stemmed from this type of "crony capitalism" in Japan, Korea and other Asian countries.

The great concern about mixing banking and commerce, of course, is the potential for banks to make credit decisions on the basis of incestuous corporate relationships, rather than on credit worthiness. Such combinations ultimately would lead to a concentration of banking and economic resources as well as creating lending decisions that could damage safety and soundness of insured banks and place taxpayer-supported deposit insurance funds at risk.

The distortion of the allocation of bank credit would eventually have a substantial adverse effect on competition and the overall productivity of the economy. It would also have a negative impact on independent banks that would likely be shut out of business

relationships with the commercial affiliates and the suppliers and customers of these affiliates..

Mr. Chairman, it is regrettable that "grandfather clauses" are contained in HR 10 which will allow some banking and commerce combinations to be continued for a period of 10 years with the Federal Reserve allowed to extend this grandfather for an additional five years. There are also grandfather clauses that allow unitary thrifts formed prior to October 7, 1998 to engage in commercial activities.

Grandfather clauses, particularly those extending a decade or longer, have a habit of becoming permanent. They also provide "lobbying fodder" for competitors who will be knocking on the doors of Congress, demanding "equal treatment" and level playing fields.

This Committee and the Senate should pay close attention to the counsel of former Federal Reserve Chairman Paul Volcker who has crusaded against the dangers of banking and commerce.

For those who would try to slip "small baskets" of banking and commerce into this legislation on the grounds that the baskets are limited and benign should remember these words from Mr. Volcker:

Once the foot is in the door, the pressure to ease the necessarily arbitrary limits, lubricated by ever larger political contributions, will grow stronger. The fissures in the dike will erode, new compromises will be struck, and the risks and concentrations will inexorably mount.

CRA SHOULD KEEP PACE WITH FINANCIAL CHANGES

The Community Reinvestment Act is one of the great success stories of our economy. It is has helped to generate a trillion dollars of commitments of bank credit in under served urban and rural areas, according to data compiled by the National Community Reinvestment Coalition. It has opened new markets for lenders. It has encouraged the utilization of private resources and has saved local, state and federal governments millions of tax dollars through the encouragement of the investment of private funds. It has raised the hopes of citizens in areas where there was little hope and has brought untold numbers of volunteers into grass roots community efforts.

But, if the Congress changes the financial landscape, as contemplated by HR 10, it is essential that CRA be "modernized" so that it remains a viable and vital part of the new system.

If HR 10 becomes law, no longer will community groups be knocking on the doors of just traditional banking corporations. In many communities across the nation, the financial center will no longer be just a bank, but giant conglomerates that may contain a big securities firm, a big insurance company, and possibly a sizeable industrial

corporation along with a bank. Management and financial resources of the conglomerates, in many cases, will be shifted from banks to affiliates. All this will mean fewer resources will available and evaluated for CRA purposes.

The turf war between the Federal Reserve and the Office of the Comptroller of the Currency (OCC) also figures to some degree in the future of CRA. If the Federal Reserve wins this battle, most of the non-bank activities will be housed in a holding company structure where CRA does not apply.

OCC is battling to retain authority for non-bank activities to be housed in operating subsidiaries in the banks. Under the OCC op-sub structure, the income flows from the subsidiaries to the bank and would be counted as part of the bank's assets which can be evaluated in judging the bank's ability to serve community needs. Under the Federal Reserve model, income flows to the holding company parent, not to the bank.

If the Committee retains the Federal Reserve holding company structure, it needs to require that the affiliates meet a CRA-like community test. Like the banks, these affiliates need to help meet the needs of their communities. Opponents of this concept will undoubtedly argue that the affiliates do not have deposit insurance and safety net protections enjoyed by banks and, therefore, there is no rationale to extend a CRA-like responsibility.

But, this argument ignores the fact that the large securities and insurance firms will be wrapped around one or more federally-insured banks in the conglomerates.. Neither regulators nor the Congress are likely to allow these affiliates to fail. If for nothing else the safety net would be extended to the affiliates for fear that their demise could drag down the insured banks in the conglomerate. The market will so assume and this will mean sizeable monetary benefits for the affiliates from this market perception.

As we know from the recent history of Long Term Capital Management, regulators--at least the Federal Reserve--are quick to leap in with rescues of financial entities, insured or not.

There is a clear rationale for non-bank affiliates--as well as banks--to be required to meet a community responsibility test. They will benefit from the federal safety net. .

The Chairman's version of HR 10 requires that, among other things, the formation of a financial holding company be conditioned on a "satisfactory" CRA rating by the banks that would become part of the holding company. But, I note that this version of the bill drops ongoing enforcement to ensure that the satisfactory level of CRA performance is maintained after the holding company is formed.

This weakens CRA significantly as it relates to financial holding companies. Banks that are part of these holding companies could just drop all pretense of meeting community needs after they pass the "satisfactory" test on opening day. This is absurd and should be corrected.

Similarly there is a big question as to why proponents of this legislation have

dropped a provision for basic "life-line accounts" that was adopted as part of HR 10 by this Committee and the full House in the last Congress? Why this retreat from the amendment that Representative Waters offered successfully in the last Congress?

While Congress talks about financial modernization for mega financial institutions, more than 22 percent of the population, according to the Population Survey of Income Dynamics, do not have bank accounts. The current version of HR 10 does nothing about this problem. Consumer and community protections were sparse enough. The new version becomes even more an "industry only" bill.

GIVE CONSUMERS A CHANCE TO PROTECT THEMSELVES

After watching the Congress struggle with industry wish lists for three Congresses and give little attention to the needs of consumers, it is time that consumers develop a more effective means of being heard on financial issues

What is needed is the formation of Financial Consumer Associations (FCAs) across the nation. These associations would be modeled on the Citizen Utility Board (CUB) concept which have been formed in states like Illinois to give consumers the means to fight rate increases and promote awareness of energy conservation.

The Illinois CUB alone helped consumers save over three billion dollars in eight years and participated in a major settlement of six cases against Commonwealth Edison, resulting in a annual savings of $272 for the average single-family residential consumer and $1,750 for the typical small business.

Financial Consumer Associations would be state-chartered, nonprofit, nonpartisan organizations. FCAs would be supported by membership dues and would receive no tax money. The members would elect a board of directors which could hire researchers, organizers, accountants and lawyers.

These associations, among other things, could represent consumers before regulatory and legislative bodies, the courts and in negotiations with financial service providers. They could, as well, develop data that would provide consumers with the facts needed to deal with financial institutions and provide a means of shopping for best bargains in the financial marketplace. They could also monitor the availability of financial services to less affluent and minority borrowers and advocate policies to ensure access to credit by all consumers.

In past Congresses this Committee has considered legislation that would allow these associations to include notices in statements, billings and other mailings of financial institutions. These mailings would include notices about the existence of the associations and an invitation to join. The mailings would not cost the financial institutions anything

and would be a modest reciprocity for the all the benefits of insurance, guarantees and the federal safety net that are bestowed on the financial industry.

The mailings are critical to the formation of FCAs. This process has been a huge success in attracting members to the Consumer Utility Boards. Legislation to authorize the FCA inserts was introduced in 1989 by Representative Charles Schumer, now the newly elected U. S. Senator from New York. The effort was supported by the then House Banking Committee Chairman, Henry Gonzalez. With the wide-ranging changes in the financial landscape contemplated by HR 10, now is a propitious moment to renew this effort.

I urge this Committee to include, as part of HR 10, an amendment would allow these enclosures in the financial corporations' mailings. This would provide a chance for a broad based group of citizens to have a chance to defend consumers in a financial world that is growing more complex by the day. We have draft language which we will be happy to provide you for an amendment to HR 10. It would do much to balance the scales against the overwhelming tilt of HR 10 for financial corporations.

NATIONAL
COMMUNITY
REINVESTMENT
COALITION

NCRC

For release upon delivery
February 11, 1999
10:00 AM

TESTIMONY OF JOHN E. TAYLOR

PRESIDENT AND CEO OF THE NATIONAL COMMUNITY REINVESTMENT COALITION

before the

COMMITTEE ON BANKING AND FINANCIAL SERVICES

of the

HOUSE OF REPRESENTATIVES

FEBRUARY 11, 1999

The remarks expressed here represent the views of 680 community reinvestment organizations that comprise the membership of NCRC.

Introduction

Good morning Chairman Leach, Representative LaFalce and distinguished members of the House Banking Committee. My name is John Taylor, and I am the President and CEO of the National Community Reinvestment Coalition (NCRC). NCRC is the nation's CRA trade association composed of more than 680 community reinvestment organizations from inner city neighborhoods and rural areas. NCRC's philosophy promotes pro-active partnerships among banks and low-income and minority communities dedicated to increasing access to capital and credit. As a trade association of neighborhood organizations, NCRC has represented the community's perspective on the Consumer Advisory Council of the Federal Reserve Board, Fannie Mae's Housing Impact Advisory Council, Freddie Mac's Affordable Housing Council and before Congress. I request that my written testimony be included as part of the official record in the *Congressional Record*.

NCRC thanks you for the opportunity to testify before you today on a subject, financial modernization, that has profound impacts on access to capital and credit for this nation's underserved communities. Over the years, community development corporations (CDCs) and other NCRC members have been engaged in countless economic development projects that successfully turn around sections of neighborhoods. But NCRC's members struggle against larger forces of disinvestment and deterioration. What they understand is that hundreds of homes and small businesses need loans in order for entire neighborhoods to be revitalized. Without sustained access to capital and credit, neighborhoods die.

Mr Chairman, I greatly appreciate your leadership in expanding the Community Reinvestment Act (CRA) to wholesale financial institutions in HR 10 or the Financial Services Act of 1999. NCRC believes, however, that CRA needs to be expanded to all non-bank financial companies allowed to affiliate with banks under the bill. If we do not expand community reinvestment obligations and

data disclosure requirements, I am afraid that CDCs and other NCRC members will face an uphill battle against decline like I did when I was a CDC director in Somerville, Massachusetts. This would be most disheartening after several years of dramatic gains in lending and investing for working class and minority neighborhoods.

In particular, NCRC urges you to extend community reinvestment requirements to non-depository institutions, like insurance agents or mortgage companies, that make loans and are affiliated with bank holding companies. We also need to expand data disclosure requirements to insurance companies and improve upon small business data disclosure as detailed later in my testimony.

The current version of HR 10 would slow down the progress in community reinvestment because it does not allow CRA to evolve with the rapid changes in the financial industry. Insurance and securities affiliates of banks are increasingly conducting lending and selling bank-like products, yet are not covered by community reinvestment requirements. As assets and banking products are shifted out of banks and into holding company affiliates exempt from CRA, the reach of CRA is reduced to a smaller and smaller portion of the nation's lending activities. CRA will not be able to leverage as many loans or investments for traditionally underserved communities if CRA is not modernized as the financial industry is modernized by HR 10.

CRA has been the most effective tool to promote the American Dream that has ever been developed. It is not a public sector program nor a burdensome regulatory requirement.[1] It simply says that depository institutions are required to serve in a safe and sound manner all the communities in which they are chartered. By combating discrimination and promoting banker-community partnerships, CRA extends the American Dream of homeownership, small business ownership, and wealth-building to millions of Americans. NCRC agrees with President Clinton when he said the other day at the U.S. Conference of Mayors that CRA should be above politics. Indeed, NCRC believes that CRA should enjoy wide bi-partisan consensus as an important element of welfare reform and the nation's strategy of providing jobs and promoting economic development in inner cities and rural areas.

The Benefits and Success of CRA

CRA improves our capitalistic system by opening up new markets for banks and by spurring the creation of entrepreneurs in our nation's distressed neighborhoods. It benefits our economy because bankers and underserved communities are asked to establish relationships and overcome barriers to lending which existed simply because of incomplete information flows. Economists and political leaders should embrace CRA as the market-based solution to our nation's economic and social problems.

Because CRA removes market imperfections and barriers, working class and minority Americans have experienced a dramatic increase in access to credit in the 1990's. In 1990, low- and moderate-income borrowers received 18 percent of all home mortgage loans made by banks. By 1997, the percentage had shot up to 28 percent. Blacks and Hispanics received 14 percent of all purchase loans in 1998 - up significantly from 10 percent of 1990. For both minorities and working class Americans, lending did not decline in any of the last eight years. It kept on

[1] Attached to NCRC's written testimony is an article from the American Banker in which small banks report that the

increasing. The lending surge is directly attributable to the federal banking agencies' improved enforcement of CRA and to the universal recognition (inside and outside of NCRC) that access to private capital is the key to neighborhood revitalization.

CRA agreements are also responsible for the boost in lending to traditionally underserved populations. Since the passage of CRA in 1977, lenders and community organizations have negotiated more than 360 CRA agreements totaling more than $1 trillion in loans and investments for traditionally underserved neighborhoods. More than 95 percent of the dollars have been committed by banks since NCRC's inception in 1992.

CRA agreements are democratic community reinvestment plans. Under the agreements, banks pledge to make specified dollars and numbers of loans and investments. Community groups help the banks succeed in achieving agreement goals by offering homeownership counseling, marketing bank products, and performing other services that help banks reach working class and minority neighborhoods. CRA results in safe and sound lending because it creates stakeholders in the community, in addition to the bank, who have a vested interest in the success of neighborhood-based lending.

For example, NCRC member the Pittsburgh Community Reinvestment Group worked with banks to identify low-income, single parent, female-headed households as an underserved market Through community meetings and homeownership counseling sessions, lending to this population group has increased significantly. Even small lenders such as Fidelity Savings Bank and Community Savings Bank have closed a significant amount of loans to single parent females in the last few years.

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new CRA exams are not burdensome.

Banks with CRA agreements are more effective in reaching minority and working class neighborhoods than those that have not made agreements. Using NCRC's database on CRA agreements, the New School for Social Research calculates that banks with CRA pledges performed the best in the minority and lower income markets. In other words, their market share of home loans to these borrowers and neighborhoods was higher than their overall market share. Banks without agreements, in contrast, had lower shares of the minority and low income market than their overall market share to all populations. These differences were statistically significant, and based on data in 1994, which was a year of high levels of lending to underserved communities.

CRA's genius is that it is a win-win for all sectors of society. Encouraged by CRA, banks have found profitable opportunities serving minority and lower income communities that they may have overlooked. In fact, a Federal Reserve study conducted by Glenn Canner and Wayne Passmore finds no statistically significant variation in profitability levels of banks that make high percentages of home purchase loans to lower income neighborhoods and borrowers, and banks that make few loans in these neighborhoods. In fact, as measured by variable net income to average assets, banks with higher volumes and percentages of loans in lower income neighborhoods were slightly more profitable than banks with few loans to lower income communities. This study considered the years 1993, 1994, and 1995 - three years of large increases in lending to minority and lower income populations.

President Clinton was correct in noting recently that no bank has gone broke making CRA loans. The banking industry has enjoyed its most profitable years ever as CRA lending has reached record heights. Banks are starting to sell their loans on Wall Street because they want more capital with which to make more CRA loans. To date, almost $2 billion of CRA loans have been securitized by Wall Street.

Critics of CRA overlook the profitability of CRA lending and the improvements CRA makes to the functioning of the free market. Instead, they focus on so-called extortion during the merger application process. In exchange for not protesting or supporting a merger application on CRA grounds, it is alleged that community groups have received funding from banks. But community groups are bad extortionists, if the critics are correct in saying that groups are out on the make. NCRC's review of CRA agreements involving NCRC members in 1997 and 1998 shows that only 1 percent of the total dollar amounts were dedicated for grants that supported CDCs, charities, and financial intermediaries like LISC and Enterprise. In dollar terms, only $9.5 billion out of $912.4 billion were grants. In addition, NCRC calculates that under $160,000 of the almost $1 trillion went specifically to CRA advocacy groups. This is virtually 0 percent.[2]

While there may be a few instances of "greenmail," NCRC and its membership renounce this practice as counterproductive to the goal of leveraging capital and credit for underserved communities. NCRC's members understand that adversarial negotiations do not produce long lasting collaborations among banks and community groups that can identify and lend to creditworthy residents of working class and minority neighborhoods. These partnerships involve a high degree of cooperation and trust. Extortion is simply not a part of the partnerships. Instead, the very small number of grants in CRA agreements are devoted to credit counseling and other services that help banks lend and invest in traditionally underserved neighborhoods in a safe and sound manner.

Homeownership, small business ownership, wealth creation, pulling yourself up by your own bootstraps - these are the reasons CRA has received bi-partisan support. This is why Chairman Leach has joined his Democratic colleagues in supporting the expansion of CRA to wholesale

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[2] The Citcorp-Travelers voluntary pledge involved largest dollar amount of loans and grants to nonprofits of $6 billion or 5.2% of their $115 billion commitment. Available materials on the pledge do not separate loans from grants, so the $6 billion represents an over-estimate of the amount of grant funding. Also, the pledge was made voluntarily when the companies announced their application to the Federal Reserve Board, and did not involve signing a contract or sending a signed letter to community groups.

financial institutions. This is why Representative John Boehner (R-OH) said he does not see "CRA problems" in the current version of HR 10 and does not understand why others would consider the community reinvestment provisions a serious problem as reported in a recent *American Banker* article.

HR 10 Should Not be Approved Unless CRA is Expanded

NCRC's 680 community-based organizations strongly believe that HR 10 (the Financial Services Act of 1998) will erode the dramatic progress in community reinvestment if CRA is not expanded to cover any financial company allowed to affiliate with banks. NCRC is pleased that the current version of HR 10 would expand CRA coverage to include wholesale financial institutions, which would be a new type of investment bank that would not be federally-insured and would be allowed to accept deposits greater than $100,000. But the piecemeal expansion of CRA would allow mortgage companies, securities firms, insurance companies, and other financial institutions to escape CRA coverage although they could affiliate with banks. This would allow holding companies to shift assets away from CRA-covered banks and thrifts into CRA exempt affiliates and subsidiaries. Such asset shifting could significantly diminish the resources with which banks and thrifts make CRA loans and investments. Surely, lawmakers do not desire new institutional arrangements which stop the creation of jobs, wealth, and small businesses in minority and lower income communities being made possible by CRA.

Cross-ownership among banks, thrifts, and non-depository institutions is likely to accelerate the drainage of assets out of banks and thrifts. In 1977, banks held 60 percent of the assets in the financial industry. In 1997, banks controlled only 27 percent of the total assets in the financial industry. Mutual funds, pension funds, insurance products and other financial instruments controlled the other 73 percent of assets. It is likely that cross-ownership among financial institutions will only intensify this asset shifting, and thus reduce the coverage and effectiveness of

CRA. In addition, CRA would not cover the checking, lending, and other bank-like activities of mutual funds and other non-depository institutions even though these entities would be able to affiliate in an unlimited manner with banks.

State Farm's new thrift illustrates the perils of financial modernization without a modernization of CRA. Even though a substantial number of State Farm's 16,000 insurance agents eventually will be originating loans across the country, the Office of Thrift Supervision (OTS) will only conduct CRA examinations in Bloomington, Illinois, where State Farm's corporate headquarters are located. The OTS claims it does not have statutory authority to expand CRA requirements to the insurance agents. State Farm does business with one in four Americans. By confining CRA to a tiny part of its service area, most of State Farm's lending activity will not be monitored by regulatory agencies for CRA compliance. This is not a recipe for increasing access to capital and credit in a post-HR 10 landscape.

While NCRC appreciates the bi-partisan approach by Congressional leaders to financial modernization legislation, the current version of HR 10 is a retreat from a number of improvements that were in previous versions. Several amendments were proposed in the House Banking Committee markup last year that would allow CRA to evolve with the structural changes in the financial industry that would be accelerated under HR 10. Rep. Luis Gutierrez (D-IL) and Rep. Carolyn Kilpatrick (D-MI) proposed an amendment that would have prevented financial holding companies from engaging in newly authorized financial activities unless the appropriate federal regulatory agency determined that all of their depository subsidiaries and non-bank affiliates served the credit and consumer needs of minority and lower income communities. Another amendment was introduced that would have required insurance company affiliates of holding companies to offer policies in low- and moderate-income communities, and that would have required securities companies to demonstrate that their branch distribution network did not arbitrarily exclude low- and moderate-income communities. Finally, the House Banking Committee last year amended HR

10 to require that holding companies offer lifeline (low cost) checking accounts. The Gutierrez amendment was not allowed to be considered on the House floor while the lifeline banking amendment was in last year's version of HR 10, but not this year's. In sum, the House has not take the necessary steps to ensure that community reinvestment gains of the last several years would be preserved and could be built upon.

HR 10 contains no sanctions for poor CRA performance. In last year's version of HR 10, the Federal Reserve Board was granted the authority to require a holding company that had banks with failing CRA grades to divest or cease the operations of insurance and securities subsidiaries. This year's version removed that provision. The current version only requires that all banks and thrift subsidiaries of a holding company have a Satisfactory and above rating when a holding company wants to acquire a non-depository institution or commence non-bank financial activities. Beyond the initial application time period, subsequent sanctions for failure to abide to CRA are absent.

But in addition to reinstating penalties for failing CRA ratings, NCRC believes that specific expansions of community reinvestment requirements and accompanying regulations are needed. NCRC envisions that insurance and securities companies could be examined under CRA tests analogous to the one for large banks. Currently, large banks are examined under a CRA lending, investment, and service test. The lending test looks at the number and dollar amounts of loans being offered to low- and moderate-income borrowers and neighborhoods in order to insure that banks are meeting the credit needs of all communities in which they are chartered. For insurance companies, a "lending" test or "policy" test, could scrutinize the number and dollar amounts of policies by income of policyholders and neighborhoods. For securities firms, the lending test equivalent could look at the distribution of mutual funds across income groups. Similarly, the investment test for insurance and securities firms could measure the amount of equity investments in affordable housing and economic development activities made by these firms. Finally, the service test for banks looks at the distributions of bank branches, ATMs, and other delivery

systems by income of census tracts. A service test for insurance companies and securities firms could examine the distribution of agents and broker offices, respectively. Since banks, insurance companies and securities firms are becoming engaged in each other's businesses and selling products from the same offices, it is not hard to imagine a CRA exam that simultaneously scrutinizes the provision of bank, insurance, and securities products.

Expand Data Disclosure Requirements

CRA-like exams for insurance and securities companies cannot be rigorous unless data disclosure requirements are expanded. The Home Mortgage Data Disclosure Act (HMDA) has enabled regulatory agencies to conduct thorough CRA exams of the home lending activities of banks and thrifts. In addition, community organizations and local public agencies have been able to leverage home loans for traditionally underserved communities by holding banks accountable for their performance. As NCRC has done in *America's Best and Worst Lenders*, HMDA data analysis pinpoints the best CRA lenders that offer the highest numbers and percentages of loans to minority and working class borrowers. It also shows the worst CRA lenders that are offering few loans to underserved populations. Community groups can then use the data analysis as a means of encouraging the laggards to adopt some of the best practices and affordable lending programs of the top CRA lenders. In this manner, HMDA data analysis has increased the number of loans to underserved populations.

A HMDA-like disclosure requirement can likewise encourage insurance companies to identify missed market opportunities. In a few states that have data disclosure requirements, NCRC members like the Massachusetts Affordable Homeownership Alliance (MAHA) have conducted data analysis to identify the market leaders and laggards in minority and working class neighborhoods in the Boston area. Their analysis reveals that loss ratios (premiums divided by claims) are lower in the most underserved zip codes than throughout the rest of the state. This

indicates that more profitable business can be done in the underserved zip codes.[3] MAHA has formed partnerships with insurance companies to offer homeownership counseling and engage in other activities designed to increase business in minority and working class neighborhoods.

Other studies reveal that federal data disclosure laws for insurance companies would expand the availability of insurance to working class and minority neighborhoods. Over a ten year time period from 1987 through 1996, the Missouri State Department of Insurance found that the percentage of dwellings insured in high minority areas declined from 57 to 48 percent. Even among wealthy zip codes, the high minority areas had only 59 percent of dwellings insured, in contrast to 85 percent of insured homes in mostly white neighborhoods. Regression analysis controlling for housing quality shows that higher percentages of minorities are associated with more limited policies.

Robert Klein, the chief economist of the National Association of Insurance Commissioners, conducted a comprehensive study collecting data on 25 metropolitan areas from 1989 through 1992. He finds that after controlling for risk of loss, a ten percentage point increase in the number of minorities in a zip code is associated with a two percentage point increase in the number of Fair plans, which are government-sponsored insurance plans of last resort for those who cannot find insurance in the private market. According to Klein, "The NAIC believes some degree of continued public monitoring is necessary to ensure that voluntary efforts are successful and sustained. This will help to motivate insurers who would otherwise engage in discrimination or fail to pursue legitimate economic opportunities to serve the inner city." Klein is right. It is time for nationwide data disclosure and community reinvestment requirements for insurance companies.

The data disclosure requirements for small business lending also needs to be improved. In a new study published by the National Bureau of Economic Research, economists David Blanchflower, Phillip Levine, and David Zimmerman document discrimination in lending to Black-owned small

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[3] The most underserved zip codes are those with the highest percentage of fair plans. Fair plans are government-

businesses. Using survey data for 1993 and 1994 of more than 4,600 businesses, the authors find that Black-owned firms experience denial rates that are 25 percentage points higher than white rejection rates, after controlling for credit-worthiness and a wide array of other characteristics of the business and the owner. Unfortunately, it appears that banks are the source of discrimination. When the authors considered applications for credit cards, they found only a 3 percentage point difference in denial rates. For banks, the differences in denial rates for similarly qualified Black and white firms was even larger than those found in the seminal Boston Federal Reserve study on mortgage lending a few years back. In addition, the Black-owned firms paid interest rates on loans that were one percentage point higher than white-owned firms.

The studies on the availability of insurance and small business loans to underserved neighborhoods were conducted using limited data sets or one-time surveys. The results make it clear that annual data reporting is imperative, and that the data on insurance activities and small business lending must include detailed characteristics on the race, income levels, sales volume, and census tract locations of the customers and small business borrowers (Currently, the new CRA small business data lacks information on the characteristics of the businesses and their owners). Detailed data disclosure makes it possible to find out who are market leaders in serving neglected customers and businesses. Then, public persuasion and sanctions, when necessary, should be used to eliminate discriminatory practices and encourage financial institutions serving few working class or minority communities to emulate the practices of their competitors who do much business in these neighborhoods.

Safety and Soundness Issues Need to be Addressed

Expansion of CRA to the new financial conglomerates, however, is not enough to allay NCRC's concerns about HR 10. NCRC believes that policymakers have not addressed the safety and

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sponsored insurance plans of last resort for homeowners unable to obtain insurance from the voluntary market.

soundness issues associated with unlimited cross-industry ownership. The recent experience after the California earthquake illustrates the serious risks associated with financial behemoths. After the earthquake, the Fire and Casualty subsidiary of State Farm processed claims almost equal to the assets of the subsidiary. What would happen in future emergencies when banking is mixed with insurance underwriting? Would the holding company draw down the resources of federally-insured depository subsidiaries to bail out the insurance affiliates? Would this leave the depository institutions in precarious financial condition?

Prudent limitations on non-banking activities are maintained in order to preserve safety and soundness. HR 10 veers too far towards lifting limits. For example, it would allow Section 20 subsidiaries to earn all of their revenue from securities operations. What seems more important than the affiliate versus subsidiary issue is the limitations on cross-industry ownership. Caps on the amount of non-banking activities conducted by subsidiaries and affiliates are designed to prevent financial difficulties by limiting the losses associated with riskier activities. But if these limitations are lifted, federally-insured institutions become dangerously exposed to sudden crises that can wipe out assets in one fell-swoop. Federal Reserve Chairman Alan Greenspan in his testimony last summer in front of the Senate Banking Committee stated that "losses in, for example, securities dealing or fire and casualty insurance underwriting conducted in an operating subsidiary could occur so rapidly that they could overwhelm the bank parent before actions could be taken by the regulator." Likewise, NCRC believes that in times of crisis, holding companies would not refrain from raiding federally insured affiliates although affiliates are supposed to have stronger firewalls.

Mr. Chairman, your astute caution on hedge funds should be followed closely and should serve as a general caution against allowing too much mixing of bank, insurance, and securities activities too quickly. Last fall, you delivered a speech on the House floor in which you indicated that "the country's most sophisticated banking institutions provided loans to an institution (Long-Term

Capital Management) that shielded its operations in secrecy, denying lenders and their regulators data about its positions or other borrowings." You concluded by saying that the "too-big (to fail) doctrine is simply too prone to fail." Long Term Capital and other large hedge funds pose systemic risk to the financial sector if they fail. But, NCRC agrees with you that market solutions and use of U.S. bankruptcy law is preferable to orchestrated bailouts by the Federal Reserve Board or government bailouts. NCRC believes that if Congress passes HR 10 in its current form, it will be consolidating the financial industry too quickly without the necessary safeguards and limits that would prevent other too-big to fail situations from endangering the most profitable financial industry in the world.

Japan, which has a more deregulated banking system than the United Sates, is confronted with $600 billion worth of bad loans. Relative to the size of its economy, Japan's crisis is six times as bad as our S&L crisis was, according to a *Washington Post* article. NCRC suggests a sober and incremental approach towards deregulating the financial industry. The bold deregulation proposed by HR 10 threatens to create an ailing industry that is unable to meet community reinvestment needs of neighborhoods across the country.

NCRC calls on Congress to ask the General Accounting Office (GAO) to thoroughly examine the safety and soundness issues and to make recommendations regarding prudential limits on cross-industry ownership. Does the recently enacted 25 percent cap on Section 20 revenue generated from securities operations preserve safety and soundness? What has been the safety track record of Section 20 subsidiaries since the Federal Reserve Board increased the cap to 25 from 10 percent in December of 1996? What caps would work for insurance affiliates and subsidiaries? What is the experience abroad with fewer limitations and safeguards? What would be the impact on working class Americans if the proposed lifting of caps goes forward?

Ironically, some argue that the laws relating to the mixing of banking, insurance, and securities should be revised because the financial industry has already found ways to circumvent the current limitations on mixing. NCRC would respectfully request that if this is the case, then Congress should act swiftly to close any such loopholes. It is this institution, Congress, that the American public has empowered to make its laws, not private industry. Congress, not private industry, has the mandate to examine the impacts of proposed changes to laws, and then decide what is in the public interest and what measures best protect the safety and soundness of the financial industry.

Impacts of Consolidation and Mergers on CRA Performance and Enforcement

Extending CRA and adding safety and soundness safeguards will not be enough. HR 10 will intensify the rate of consolidation in the financial industry by authorizing additional combinations of banking, insurance, and securities operations. In this environment, CRA enforcement must be toughened. Mergers will lead to declines in CRA-related investments and loans if regulatory enforcement is lax and citizens do not have opportunities to make their views known during the merger application process. HR 10 must require a merger application process and a public comment period for all types of proposed mergers and combinations. Currently, the bill would allow most bank holding companies to merge with non-depository institutions such as mortgage companies and insurance firms without submitting an application to federal banking agencies.

A number of studies suggest that mergers and acquisitions decrease CRA performance, particularly in the small business lending area. Economists Joe Peek and Eric Rosengren of the Federal Reserve Bank of Boston suggest that the acquisition of small banks by their larger counterparts is troublesome for small businesses since small banks make most of their loans to small businesses. Of the eleven largest mergers in New England during 1993 and 1994 examined by Peek and Rosengren, eight of the post-merger institutions decreased their small business lending. Similarly, Federal Reserve economist William Keeton found that bank consolidation decreased small business

lending in the Midwest and Mountain states. Keeton's study showed that the greatest difference in small business lending was among independent banks that had a small business loan (defined as a loan less than $100,000) to deposit ratio of 6.6% and out-of-state multi-bank holding companies with a ratio of 4.7%. In other words, the interstate merger trend is creating precisely the type of bank least likely to lend to small businesses.

Keeton's findings are supported by a study conducted by economists Robert DeYoung, Lawrence Goldberg, and Lawrence White that also concludes that independent banks offer more small business loans than multibank holding companies. Finally, Federal Reserve economists Allen N. Berger, Joseph M. Scalise, and University of Chicago economist Anil K. Kashyap estimate that small business lending will continue to decline in the next three to five years at the same pace (about 33 percent) as the last five years. They hypothesize that much of the sharp drop of small business lending is due to industry consolidation and the disappearance of small banks. In a recent Staff Report published by the Federal Reserve Bank of New York (December 1998), Berger, et. al. conclude from an extensive literature review that "consolidations of large banking organizations tend to reduce small business lending..."

A report by NCRC member, the Woodstock Institute, reveals that the five banks issuing the highest numbers and percentages of small business loans to lower income neighborhoods in Chicago were banks with assets under $1 billion. In contrast, bank holding companies with more than $10 billion in assets made a relatively small proportion of their loans in these neighborhoods. As the Woodstock Institute's study suggests, the continued loss of small banks is indeed worrisome since small banks with less than $300 million in assets account for close to 50 percent of small business loans under $250,000, according to the Independent Bankers Association of America.

Small business lending declines after a merger because it is a type of lending that depends on intimate knowledge of community residents and businesses that only loan officers in local branches possess. After mergers and acquisitions, decision-making is often centralized in headquarter offices located hundreds of miles away from what used to be the local branch office. Local CRA-related lending and investing can be protected only by a thorough merger application process that allows regulatory agencies, community groups, and lenders to figure out how CRA performance can be strengthened after dramatic institutional changes following mergers. During the merger application process, community groups and lenders will sign CRA agreements specifying multi-year commitments to offer housing, small business, and community development loans and investments.

Community group input regarding the First Union-Corestates merger is an example of how CRA gains can be preserved by a participatory merger application process. First Union, a regional bank that competes vigorously with Nationsbank, had just taken over Corestates, the last regional bank headquartered in Philadelphia. This merger posed significant dangers to the economy of Pennsylvania, as it involved the potential closure of hundreds of branches and the loss of thousands of bank jobs.

After negotiations between community organizations and First Union, the bank agreed to offer $250 million annually in home loans in Pennsylvania to low- and moderate-income borrowers. This was a slightly higher level than First Union and Corestates was offering before the merger. In addition, the bank will establish a $25 million fund for job counseling and retraining of former employees as well as promising to make $250 million annually in small business loans and $75 million annually in community development lending. Finally, the bank agreed to offer a free checking account and to adopt a "no-fee" ATM policy.

The First Union CRA agreement was the result of an arduous process. The Federal Reserve Board, which was the lead federal regulator on this merger, grudgingly held public hearings on the merger and extended the public comment period, but only after a public outcry from more than 100 community groups and after the intervention of Pennsylvania's two U.S. Senators and a bi-partisan group of elected officials. In addition, the Attorney General of Pennsylvania will enforce the terms of First Union's agreement, especially the "no fee checking" and ATM provisions for low-income recipients of Social Security and other federal benefits.

Why did it require the intervention of U.S. Senators and state and local officials to ask the Federal Reserve Board and the bank to seriously consider the merger's ramifications to traditionally underserved communities? This process of preserving community reinvestment should be an automatic component of the merger application procedure; it should not be an excruciating exercise that depends on the good will of elected officials.

In detailed policy recommendations below, NCRC suggests that the merger application process must include public hearings and the submission of community reinvestment plans by the merging banks. Since it is clear that bank modernization legislation will intensify the pace of consolidation in the financial industry, public policy must counter the strong forces accompanying consolidation that hasten disinvestment from our nation's underserved communities.

Combinations of Financial and Non-Financial Companies

In many areas, bank modernization's winners and losers will depend on the regulatory framework that accompanies modernization. In one aspect though, it is clear what the impact of bank modernization is. Proposals to allow combinations of financial and non-financial companies are harmful to everyone - communities and corporations alike.

Safety and soundness in the financial industry will deteriorate significantly if financial holding companies are allowed to affiliate at all with non-financial corporations. We should learn from the mistakes of foreign countries who have had particularly disastrous experiences allowing combinations of financial and non-financial companies. In Finland, combinations of commerce and banking resulted in losses that in proportion exceeded our savings and loan crisis. One of the world's biggest bank failures totaling $14 billion involved the Credit Lyonnais in France which was a banking and commerce conglomerate. In Spain, Benesto had a similarly spectacular collapse. Later, it was taken over by Banco Santandor, which had sold off all its non-financial businesses and invested the proceeds in our own First Fidelity.

A contributing factor to failures would be bank and non-financial corporate combinations because banks would no longer impartially allocate credit. They would be motivated to extend credit to their non-financial affiliate even if other businesses may be more creditworthy. If a non-financial affiliate of a bank is mismanaged, the bank has an incentive to continue financing it in hopes that its condition improves. More credit, however, simply feeds the mismanagement rather than rectifying it. Thus, huge bank and non-bank conglomerates fail because the non-financial affiliate is never subjected to the discipline of receiving less credit or no credit until its managerial practices improve. Overall economic efficiency declines in countries with bank and non-financial conglomerates.

The romance with bigness involves notions of efficiency improvements due to economies of scale and protections from risk due to diversification. Economies of scale, however, are not always achieved by larger organizations. Within the banking industry in particular, size has consistently failed to realize efficiency gains. Reviewing banking industry studies conducted between 1980 and 1993, Federal Reserve economist Stephen Rhoades concludes that "...findings point strongly to a lack of improvement in efficiency or profitability as a result of bank mergers. These findings are robust within studies, across studies, and over time." Banks and non-bank financial corporations

may perceive financial industry consolidation as an attractive means to increase market share and profitability. Whether it will increase overall economic efficiency is not at all clear. In fact, the available evidence suggests that it will not. And finally, if bank modernization is to avoid endangering the safety and soundness of the financial industry, it should not permit bank and non-financial corporate affiliations. Ample evidence from abroad indicates that rather than decreasing risk, this type of diversification only increases it.

The entry of banks into non-financial activities will impede the growth of the small business sector. Banks would favor their commerce affiliates over independent small businesses in their lending and investing decisions. Small businesses in lower income and minority neighborhoods will be particularly disadvantaged since they have the greatest need for loans. Allowing banks to aggressively enter the non-banking industry thwarts the CRA's emphasis of small business development in inner city neighborhoods and underserved rural areas.

NCRC is pleased that the Chairman is intent on prohibiting financial holding companies from acquiring non-financial corporations. However, NCRC is concerned that HR 10's grandfathering clauses are too generous as they permit holding companies to earn up to 15 percent of their revenues from non-financial companies for a period of 10 years with a possible five-year extension.

Public Obligations of Financial Institutions

Some laissez-faire proponents of financial modernization ask why should financial institutions be subjected to community reinvestment obligations. Financial institutions have an obligation to serve all segments of the population because governments nurture their growth and protect their assets. Federal and state governments use their authority as representatives of the citizenry to grant financial institutions charters. In other words, financial institutions have an obligation to serve all

members of the public because the citizenry allowed them to exist. Section 802 of the Community Reinvestment Act creates a legal obligation on the part of depository institutions "to serve the convenience and needs of the communities in which they are chartered." *Chartered* is the key word: all other non-bank financial institutions also receive their right to exist through a publicly granted charter. Therefore, they should have a legal obligation to serve the financial needs of the communities in which they are chartered.

The public, through their government agencies, protects the safety and soundness of chartered financial institutions. Policymakers first applied CRA to depository institutions because federal deposit insurance is ultimately backed by the taxpayers. Yet, Mark Pinsky's and Valerie Threlfall's article for the National Association of Community Development Loan Funds points out that most non-bank financial institutions also receive substantial government protections. For example, according to Pinsky and Threlfall, the Securities Investor Protection Corporation has the authority to borrow up to $1 billion dollars from the U.S. Treasury in order to reimburse investors of insolvent brokerage firms. Likewise, the insurance fund for pension plans has a line of credit from the U.S. Treasury that can be used in emergencies.

Consumer Disclosure and Protection

In order to protect consumers, new regulatory and legislative initiatives will have to accompany bank modernization legislation. Financial holding companies will be able to offer a dizzying array of bank, security, and insurance products while worrisome evidence abounds that the banking industry is not properly disclosing the risk associated with nondeposit investment products. An FDIC-sponsored survey, which is regarded as the most comprehensive monitoring study to date, found that in nearly 4,000 "mystery" in-person visits, bank and thrift representatives did not disclose to potential customers that investment products including mutual funds were not federally insured 28 percent of the time. In the almost 4,000 telephone calls by "mystery" customers.

representatives of lending institutions did not properly disclose information to customers an incredible 55 percent of the time.

NCRC is pleased that HR 10 contains provisions protecting state disclosure laws and requiring the Federal banking agencies to develop disclosure laws as well. NCRC, however, supports the position of Consumers' Union and Ralph Nader that an amendment to HR 10 is needed that establishes a federal law and regulations protecting the privacy of consumer data. The federal law would empower consumers to decide if they want financial institutions to share their data with their affiliates or outside companies. The financial institution would be required to obtain verbal and written permission for data sharing. This provision would protect minority and working class consumers from unscrupulous use of information about their financial and credit status. For example, if a consumer applied for a loan, a bank should not be allowed to share the applicant information with a subprime affiliate unless authorized by the consumer. Unauthorized data sharing promotes steering of minorities and lower income customers into high priced, subprime loans when these consumers actually wanted their application considered by the traditional bank, not the subprime affiliate.

Expanding CRA Would Increase Wealth for Millions of Americans

CRA has imposed obligations to serve the public because it has lead to enormous benefits for financial institutions and for the country as a whole. Banks have discovered that CRA lending is a profitable business and are starting to sell their CRA loans on Wall Street so that they can make more CRA loans. Would not other financial institutions also discover that community reinvestment requirements open up profitable business opportunities? In addition, financial institutions benefit from community reinvestment obligations because community reinvestment laws improve the overall economic and social health of the nation. Former Comptroller of the Currency, Eugene Ludwig, exclaims that the "democratization of credit," brought about by the CRA, benefits

neighborhoods, regions, and the country by revitalizing depressed neighborhoods into vibrant communities with job growth and reduced levels of violence and crime.

Financial modernization creates an opportunity to even broaden the social benefits of community reinvestment obligations. If CRA obligations are extended to pension funds, mutual funds, and other non-depository institutions, the nation will experience a democratization of wealth. Millions of low-income Americans could have access to mutual funds, pension funds, and life insurance policies which will not only increase their wealth, but the wealth of the communities in which they reside. In a paper sponsored by the U.S. Department of Commerce, T.J. Eller and Wallace Fraser find that the median net worth of white households was about $46,000 while the median net worth of Black and Hispanic households was about $4,600 (or only *one-tenth* of their white counterparts). It is time to extend CRA to the rest of the financial industry in order to reduce the extreme inequalities in wealth that exist in this country.

Providing opportunities for wealth accumulation is the secret to this nation's prosperity and the unparalleled prosperity of its financial industry. What could be a better rationale for extending CRA?

Policy Recommendations

In the last few years, gains in Community Reinvestment Act lending have been impressive. Lenders offered an incredible 72% increase in conventional home purchase loans to African-Americans, a 45% increase to Hispanics, and a 40% increase to low- and moderate-income households from 1993 to 1997. While impressive, the gains in community reinvestment lending are fragile. Even though CRA lending has proven to be profitable, banks and thrifts could once again neglect disadvantaged communities if HR 10 allows depository institutions to affiliate with

financial companies exempt from CRA. In order to preserve and build upon the community reinvestment gains of the last few years, NCRC recommends the following:

Reinvestment Provisions for a Modernization Bill

Expansion of CRA and Consumer Service Obligations

1. CRA must be extended to all affiliates of bank holding companies. (Not in H.R. 10)

2. CRA must be extended to all operating subsidiaries of federally-insured financial institutions. (Not in H.R. 10)

3. Bill must extend a CRA-like law to mortgage companies, finance companies, and credit unions regardless of their affiliation with banks. (Not in H.R. 10)

4. Bill must extend CRA coverage to the newly allowed Wholesale Financial Institutions (WFIs). WFI's would not be federally-insured and only accept deposits of over $100,000. (H.R. 10 extends CRA to WFI's.)

5. Bill should extend a CRA-like law to securities firms, investment companies, investment advisors, mutual funds, or else develop a new National Reinvestment Fund that these industries are asked to fund. (Not H.R. 10)

6. Bill must require "lifeline banking accounts" for all depository institutions. (Not in H.R. 10)

Data Disclosure

7. Bill must extend CRA-like and Home Mortgage Disclosure Act (HMDA)-like provisions to insurance companies and to insurance activities that will be newly allowed in bank holding companies. (Not in H.R. 10)

8. Bill must improve upon the small business data reporting recently required under CRA. Specifically, lenders must be required to report on the race and gender of the business owner and the sales volume (expressed in dollars) of the business. In addition, lenders should be required to report the specific census tracts in which the loans were made in addition to the current requirement of reporting the income levels of the census tracts. In addition, denials must be reported as well as approvals. (Not in H.R. 10)

Regulatory and Structural Issues

9. Bill must require an application process for mergers between depository institutions and non-banking financial entities, with regulatory approval based at least partially on the CRA records of the institutions. (H.R. 10 would exempt most of these mergers, when combined assets are below $40 billion, from the application process)

10. Bill must prohibit mixing commerce and banking so as to preserve the safety and soundness of the banking industry and to ensure that minority and low- and moderate-income communities are served. (The Leach amendment eliminated commercial baskets in HR 10. The bill's grandfathering clause is too generous. Holding companies should divest existing commercial companies sooner than the 10 to 15 year time period allowed by the bill.)

11. Bill must maintain thrift charters and clarify that all activities undertaken by thrifts are covered by CRA. (Last year, Rep. McCollum (R-FL) unsuccessfully introduced an amendment that would have abolished the thrift charter.)

12. Bill should establish an advisory council on community revitalization that would examine the impact of the financial modernization bill on community reinvestment and issue annual recommendations to Congress for increasing access to credit and capital for traditionally underserved populations. An annual report on H.R. 10's impact on CRA enforcement and community reinvestment should be submitted to Congress. (The Banking Committee's bill had this provision; deleted in current version of H.R 10.)

NCRC's Recommendations for the Merger Application Process

1. Financial institutions must be required to submit a community reinvestment plan specifying the levels of home, small business, and community development lending offered to low- and moderate-income individuals and communities in metropolitan and non-metropolitan areas after the merger. The plan should also outline investments and services targeted to the traditionally underserved. A portion of any cost savings derived from the merger should be devoted to the community reinvestment plan, rather than solely accruing to the shareholders and senior management of the lending institutions.

2. Financial institutions should be required to discuss whether they intend to offer low-cost or no-fee checking and savings accounts, and ATM services.

3. Financial institutions must be required to disclose proposed branch closings by neighborhood so that the impact of closings on lower income and minority neighborhoods can be determined.

The Officer of the Comptroller of the Currency requires a list of branch closings in an application. The four financial institution regulatory agencies are now considering adopting a common merger application form that would include mandatory reporting of branch closures.

4. All of the federal financial institution regulatory agencies must grant public hearings and extensions of public comment periods at the request of community groups and other members of the public. Currently, only the Office of Thrift Supervision has a mandatory requirement of this nature.

5. All of the federal regulatory agencies must conduct analyses on the level of competition on a city and neighborhood level in addition to their current multi-county and state level analyses. The recent Federal Reserve approval order of the First Union-Corestates merger seemed to dismiss anti-trust analysis conducted for smaller geographical areas although levels of concentration were much higher in Philadelphia than in the multi-county area surrounding the city.

NCRC's Recommended GAO Study

1. NCRC is pleased to announce that several Representatives requested that the GAO assess the impact of mergers on the level of CRA-related lending and investments. In addition, the GAO is studying fair lending enforcement. Both studies are expected this summer or fall.

2. In addition, NCRC recommends Congress also asks the GAO examine the impact of mixing banking and commerce. NCRC believes that mixing banking and commerce would reduce economic efficiency by distorting the impartial allocation of credit and would decrease lending to small businesses in disadvantaged neighborhoods since bank holding companies would own small firms.

3. Finally, the GAO study should examine safety and soundness issues associated with mixing banking, insurance, and securities. Almost two years ago, the Federal Reserve Board increased the amount of revenues that could be generated from securities activities from 10 percent to 25 percent in Section 20 subsidiaries. What has been the safety and soundness impacts of this change? What would be the impacts of removing these limits altogether? Of allowing bank operating subsidiaries in addition to affiliates to perform these activities? What safeguards should be added regarding investments by banks in hedge funds?

AMERICAN BANKER
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Small Banks Give Thumbs-Up To Streamlined CRA Exams

By JARET SEIBERG

The revised Community Reinvestment Act rules for small banks have been in effect for only a month, but bankers and regulators are satisfied with the new exams.

"We are done with it, and it was definitely less burdensome," said Marty Pressau, the CRA officer at First National Bank of Slippery Rock in Pennsylvania. "We had only one examiner from the Comptroller's New York office. She got here on a Wednesday at 1 p.m. and left the following day at noon."

The examiner focused on the $147 million-asset bank's loan-to-deposit ratio, file reviews, and the location of loans, he said.

"It was a lot less time-consuming," he said. "They are not requiring a lot of documentation."

First National's experience is typical of the initial reactions from other small banks, said Karen Thomas, director of regulatory affairs at the Independent Bankers Association of America.

"We are hearing that the examiners are in a learning mode," she said. "So they are trying not to be hyper technical with people. They are not being sticklers."

Karen Thomas
Director of regulatory affairs, Independent Bankers Association

She said the review of a $100 million bank took only three days, even though it hadn't had a CRA exam for five years.

"This is a good first sign that the streamlined exam will reduce the examination burden for small banks," she said.

Examiners said they also are satisfied. "It is early in the process yet, but we have been getting positive feedback," said Bert Otto, the acting deputy comptroller for compliance management. Mr. Otto said the agency will develop a best practices book for bankers based on the initial exams to provide examples of successful CRA efforts. The book is expected this summer.

Regulators adopted revised CRA rules last April that replaced the 12 assessment factors with a three-pronged test focusing on lending, service, and investment. Most of those rules take effect July 1, 1997.

But several provisions took effect Jan. 1. These include a streamlined review for banks with less than $250 million in assets and a requirement that large banks collect data on the location and size of small-business loans.

While small banks reported few problems, the big banks said the new data collection requirements have not gone smoothly. One official at a large bank said his institution is still trying to computerize the data collection.

"You've got to draw data from a lot of places," the banker said. "It turns out to be pretty complex. To automate all those things on day one is not possible."

The banker said his institution is forced to collect the data manually, which is much more expensive. □

Center for Community Change

TESTIMONY OF

DEBORAH GOLDBERG
Neighborhood Reinvestment Specialist

on behalf of the

CENTER FOR COMMUNITY CHANGE

on

H.R. 10, the "FINANCIAL SERVICES ACT OF 1999"

before the

COMMITTEE ON BANKING AND FINANCIAL SERVICES

UNITES STATES HOUSE OF REPRESENTATIVES

February 11, 1999

1000 Wisconsin Avenue NW, Washington, DC 20007 202-342-0567 Fax: 202-333-5462

Good afternoon, Mr. Chairman and members of the Committee. My name is Deborah Goldberg, and I am a Neighborhood Reinvestment Specialist with the Center for Community Change. I appreciate the opportunity to present the Center's views on the "Financial Services Act of 1999," or H.R. 10.

The Center for Community Change (CCC) is a national, not-for-profit organization established some 30 years ago to provide direct technical, research and other types of assistance to local, community-based organizations serving the needs of low and moderate income and predominately minority communities across the country. An important part of our work is building the capacity of these local citizens' groups to assess local needs and develop effective revitalization strategies using public and private sector resources. CCC also monitors the progress of the federal banking agencies' enforcement of the Community Reinvestment Act (CRA), the Home Mortgage Disclosure Act (HMDA) and the nation's fair lending laws.

Mr. Chairman, we are glad that you on holding this series of hearings on H.R. 10. It is very important that there be the opportunity for a broad range of views to be heard on legislation that will have as profound an impact on the way financial business is conducted in this country as this bill would have. Yet, despite the hearings this week, and all the previous hearings on previous versions of this bill, a compelling case has yet to be made for enacting this type of financial restructuring legislation. This is the third time in as many Congresses that legislation to repeal the Glass-Steagall Act and "modernize" the financial system has come before this Committee. Last year's bill, which passed both this Committee and the full House of Representatives by the narrowest of margins, came closer to enactment than ever before. Yet, when the 105th Congress adjourned without passing a bill, there was no hue and cry from the public. I daresay most ordinary Americans were unaware that H.R. 10 was even under consideration, let alone that it failed to make its way through both Houses of Congress. There is simply no evidence that the broad public wishes to see Congress make such sweeping changes in the way that banks relate to their local communities.

To the contrary, what we find in our work is that many residents of urban neighborhoods and rural communities are instinctively wary of what further "modernization" will mean for their ability to access deposit and credit services. And with good reason. Broadening the authority for banks and other types of financial services firms to affiliate with one another is likely to result in unprecedented levels of concentration and consolidation within our financial system, giving rise to a handful of superbanks. Indeed, Citigroup, the $700 billion entity created by last year's merger between Citicorp and Travelers, is predicted to become a $1 trillion institution within just a few years. Not long ago, a financial institution of this magnitude was barely conceivable. Today, it may be conceivable but it is no less mind-boggling. How well will Citigroup and the other superinstitutions that this legislation will foster serve the needs of their local communities? That remains to be seen, but the evidence provided by the megabanks created in the last few years gives many community groups cause for concern.

The experience that consumers and community groups have had to date with very large banking institutions has been, at best, mixed. While large institutions have the capacity to commit large amounts of resources, should they so choose, they have other characteristics that are less beneficial to underserved communities. They tend to be more expensive, especially for customers with small accounts and modest requirements for banking services. Survey after survey has shown that bigger banks charge higher fees for basic banking services. Periodic press reports indicate that these same institutions sometimes structure their fees and account terms in ways that

are intended to discourage small depositors from using bank services, or even from using the bank at all. In the community development arena, groups often find that the biggest banks are less flexible, and less willing to adapt their programs and products to the particular needs and conditions in specific local markets. Small businesses and small, family-owned farms are especially vulnerable to the trend toward bigger and bigger financial institutions. Large banks lack the institutional compatibility with small businesses that small banks have. Surveys show that the biggest banks provide only a tiny fraction of the credit for small firms. Thus, the merger trend could restrict credit access for the very companies that are producing new jobs for the economy

It is argued that H.R. 10 is badly needed to set the ground rules for the industry restructuring that is already underway in order to facilitate better integration between different segments of the financial services industry. Assuming that this is true, we believe that Congress must act at the same time to modernize the laws that protect consumers and communities that are most vulnerable to the disinvestment forces that this bill threatens to unleash. So far, this has not happened.

In testimony on this bill last year, Treasury Secretary Rubin noted that in drafting financial modernization legislation, Congress is "writing the constitution for the financial system of the next century." We completely agree with his assessment, and we urge you to take the time to draft a constitution that serves not only the desires of the various industry groups, but more importantly, the needs and concerns of the general public. Last year's bill failed to do this, and consequently was opposed by my organization and many other national community, consumer, civil rights. faith-based organizations and labor unions. (See Attachment #1.)

The debate over financial restructuring need not and should not be viewed through a narrow lens. It provides a rare and historic opportunity for a broader discussion about the type of banking and financial system that American families and communities want and need. Financial modernization legislation must also address the appropriate consumer protection, obligations and other public responsibilities that should be applied to banks and their affiliates under the new financial order.

We believe that H.R. 10, as it stands now, is fundamentally flawed and profoundly anti-consumer and anti-community in its impact.

In particular, we are concerned that H.R. 10 would diminish the effectiveness of the Community Reinvestment Act (CRA). We fear that the financial conglomerates envisioned under H.R. 10 would shift activities into holding company affiliates where CRA does not apply. This would further erode the financial assets under the Act's scope.

In addition, we are concerned that H.R. 10 does away with all meaningful prior approval and public input requirements regarding cross industry mergers. Instead, many financial conglomerates are permitted to self-approve these affiliations providing their bank subsidiaries meet a handful of modest regulatory requirements. Conglomerates over $40 billion in combined assets will be subject to a truncated procedure. And in neither case will the Federal Reserve Board have access to a full range of enforcement tools should these companies fall out of compliance with the community reinvestment standards established for cross-industry affiliations.

This bill also ignores safeguards that would prevent financial holding companies from owning insurance companies engaged in redlining of neighborhoods or other discriminatory

underwriting practices that are harmful to older urban areas and minority homeowners. This Committee included a provision to address this problem in the bill it passed last year, but that provision has been stripped out of the bill before you today.

Now let me address the specific concerns we have with H.R. 10.

H.R. 10 Would Diminish the Effectiveness of the Community Reinvestment Act

Enacted 22 years ago, the Community Reinvestment Act imposes on banks and thrifts an affirmative obligation to help meet the credit needs of their entire communities, including low and moderate income areas. This short and simple law has proven to be an indispensible tool for stimulating bank lending and investment to underserved communities and households all across the country, in both urban and rural communities. As Federal Reserve Board Chairman Alan Greenspan said in testimony before the Senate last year, CRA "has encouraged banks to develop credit products and services in response to identified needs of their communities."

In its 22 years of existence, CRA has proven its worth. Current estimates are that during these years CRA has resulted in commitments for approximately a trillion dollars targeted for affordable housing, small business development and expansion, and other types of community development efforts. It has fostered effective partnerships between banks, community groups and government agencies to address pressing local needs and open up new opportunities for people whose options were previously limited. This increased activity has occurred in ways that are both prudent and profitable for banks. And the latest CRA rules, developed a few years ago by the federal banking regulatory agencies with considerable input from lenders, community groups, local officials and others, place greater emphasis on the lending activities of banks and addressed the complaints that some lenders had about certain aspects of the law's administration.

Some have argued that H.R. 10 would strengthen CRA enforcement, since it requires that the depository institution affiliates of bank holding companies that want to merge across industry lines achieve at least a satisfactory CRA rating. However, the enforcement value of this standard is largely illusory. In recent years, 97-98% of banks have been rated as satisfactory or better under CRA by the federal banking regulators. Given this ratings distribution, it would seem that large financial holding companies created by H.R. 10 would have little difficulty satisfying this requirement. Further, this standard is a one time deal. While banks would have to maintain on-going compliance with capital and management standards under the bill, the same is not true for the CRA standard. Nor does the bill provide the Federal Reserve Board with a full range of enforcement tools for banks that might fall out of compliance, although it gives the Board the ability to issue cease and desist orders or even demand divestiture of banks that fall below the capital and managment standards established. These limitations severely reduce the impact of the modest CRA standard provided by the bill.

On the other hand, H.R. 10 poses some very real dangers for the future effectiveness of CRA. We fear that the financial conglomerates permitted under this bill would shift activities and assets away from banks and into holding company affiliates where CRA does not apply.

The long-term erosion of the financial base for CRA is already a significant problem Twenty-one years ago, when CRA was signed into law, banks and thrifts controlled nearly 60% of all financial assets. Today, insured depository institutions control only about half that amount.

In 1977, insured depositories made about 80% of all mortgage loans, compared to their present market share of 42%. (See Attachments #2 and #3.)

The shift of assets away from depository institutions has important consequences for CRA and the resources that are available to support community lending needs. Research shows that non-depository lenders, which are not covered by CRA, tend to have much weaker community reinvestment records than do their depository institution counterparts. In fact, some of these non-depository institutions are active in low and moderate income and minority communities, offering products that are at best high priced and at worst downright predatory. Ironically, some of the lenders with poor records are owned by the same holding companies that own insured depository institutions with satisfactory or even outstanding CRA ratings. From the perspective of the residents of those communities, it makes no sense that some of the holding company's affiliates are under a mandate to serve local credit needs while other affiliates are free to exploit borrowers who may not be aware of the better options that exist.

H.R. 10 threatens to reinforce the shift in assets away from CRA-covered institutions. It does this by curtailing the ability of national banks to engage in new financial activities through operating subsidiaries. It would also encourage this shift through the establishment of "financial holding companies," whose principal asset would not necessarily be a bank, but instead could be an insurance company or securities firm.

Given these trends, we believe that the CRA-type responsibilities of bank affiliates must be adapted to the changing banking environment. These requirements must be "modernized" at the same time that Congress is rewriting the other laws governing the structure of the financial services industry.

Advantages of Bank Operating Subsidiaries for CRA Purposes

One of the more contentious debates around H.R. 10 has been over the question of whether certain types of activities should be conducted through bank operating subsidiaries or through financial holding company affiliates. While this kind of structural question might normally be off the radar screen of community groups in low income neighborhoods, it has potentially important implications for CRA.

Key among these is the way that a bank's performance is likely to be affected by whether it chooses to operate a subsidiary to engage in these activities, or whether it is required to conduct these activities exclusively through a holding company affiliate. It is our view that there are potential advantages to allowing banks to continue to use the subsidiary option.

The banking regulators, in either case, look directly at the activities of either subsidiaries or affiliates only at the option of the bank that is being examined. However, the interpretation the OCC uses with respect to operating subsidiaries permits the agency to look at the additional resources that exist within the subsidiary structure. The OCC requires national bank examiners to include operating subsidiary assets when assessing the capacity of a national bank for reinvestment (See OCC Bulletin 97-26). In practical terms, what this means is that in the case of a \$100 billion bank with a \$50 billion subsidiary, examiners would combine these resources and view the bank as a \$150 billion institution when establishing the "performance context" for CRA evaluation

purposes. This could make a difference in assessing the resources committed by the combined institution for community lending.

In contrast, the Federal Reserve does not take an affiliate's size into consideration in setting the appropriate CRA standard for measuring a bank's CRA performance.

Thus, to the extent that H.R. 10 shuts down national banks' ability to engage in new financial activities through a subsidiary structure, and instead requires them to conduct these activities through affiliates, it may have the effect of shrinking the CRA "pie."

Shifting Bank Assets Out From Under the CRA Umbrella

We have a much more fundamental concern about the impact of H.R. 10, and the financial conglomerates that it authorizes. This structural change is likely to accelerate the trend toward moving financial assets outside of banks. The bill establishes "financial holding companies," whose principal asset may not be a bank, but could be an insurance company or securities firm. This represents a major departure from the traditional bank holding company structure, in which one or more banks were the major assets. The danger we see with this new approach is that is has the potential to drain funds away from communities as the management and financial resources of these new conglomerates are dominated by non-bank interests.

Although depository institutions have been losing market share, it is important to note that this does not necessarily mean that their parent companies are losing the business. Nearly one-third of the country's bank holding companies operate consumer finance affiliates, and nearly a quarter of them operate mortgage banking companies. Many bank holding companies also own commercial finance companies and small business investment companies (SBICs). Thus, the nation's largest companies are able to shift their financial assets into non-bank financial institutions, which are not covered by CRA.

The emergence of insurance and securities-owned holding companies is likely to tip the balance even further in this direction, shifting more bank assets into affiliates that are not covered by CRA. In fact, lending affiliates are already being used by large financial companies to facilitate tiered-marketing plans for different categories of consumers. Some of these practices have come under fire, with consumer and community groups charging that these affiliates are engaging in predatory lending or racial steering at the expense of low income and minority consumers. When this bill was under consideration in the last Congress, NationsBank was one of the companies under fire. (See "The Two Sides of Lending," *US News & World Report*, 12/9/96.)

Further, the account structures and fee schedules mentioned earlier that many large banks are experimenting with already are calculated to discourage small depositors from using bank services or to price them out of the institution altogether. This sorting process is likely to become even more pronounced as the banking, securities and insurance industries become more entwined. The search for the most profitable customers, who will make the greatest use of the broadest range of products offered in companies' one-stop shopping "stores" will inevitably come at the expense of those customers who have more limited need for financial services.

CRA is largely inadequate in this area. Under the current rules, the records of affiliates are not normally considered by the federal regulators as part of their CRA performance evaluations for banks, except at the election of the parent company. Thus, a bank holding

company can choose to have the activities of its mortgage company or other lending affiliate included in the CRA exam when it believes they will improve an otherwise inadequate record of the bank. However, regulators are powerless to consider even the most egregious record of a lending affiliate if the parent chooses to exclude that record. This one-way approach to regulation no longer makes sense.

Even where assets are not shifted out of insured depositories into affiliates that are not covered by CRA, the new ways of business that emerge from the combination of financial services companies may also undermine CRA. We are getting a preview of one way this can happen through the plans of some of the insurance companies that have recently received permission to operate thrift institutions. Some of these companies -- State Farm and Travelers, in particular -- propose to make their insurance agents into *de facto* bank branches, using the agents to market bank products. Yet banks are only examined for CRA compliance in communities where they have brick and mortar branches; these new flesh and blood branches don't count. Under the current system, examiners do not determine what communities a bank may be doing business in through these new delivery systems, and do not investigate the question of whether or not it is serving its entire community, including low and moderate income areas, in those locations where insurance agents substitute for traditional bank branches. The bill will only expand the number of such arrangements, further weakening the scope and effectiveness of CRA.

New Uninsured Banks Only Nominally Covered by CRA

H.R. 10 authorizes the creation of a new type of uninsured depository institution: a "wholesale financial instition" or "woofie." Although not permitted to take FDIC insured deposits, these banks would be afforded the same ability to borrow from the Federal Reserve Board's discount window as insured banks.

Mr. Chairman, we are glad that you have once again proposed that woofies would be covered by CRA. However, this does not alleviate our more fundamental concern about woofies and their impact on the resources available for community development purposes in low and moderate income and minority communites across the country.

One factor that causes our concern is the way that CRA would apply to woofies. Presumably these new institutions would be evaluated under the "wholesale" bank CRA test that is currently applied to wholesale and limited purpose institutions. This is a less rigorous test than the three-pronged lending, service and investment tests that are applied to large retail institutions.

An even greater cause for concern than the application of a less stringent CRA test is the impact that woofies may have on the availability of credit in neighborhoods and underserved communities across America. By definition, wholesale institutions do not play the same role in providing access to credit and banking services at the local level. They don't have branches, they don't offer the types of accounts, services and products required by individuals and the small businesses that are so critical to healthy neighborhoods.

Recently, Bankers Trust has been in the news for its partnership with Delta Funding, a Long Island-based mortgage company that is active in low income communities within New York as well as in 21 other states. A wholesale institution, Bankers Trust works through other entities to carry out its CRA obligations. It has helped Delta Funding finance hundreds of millions of dollars worth of high interest rate mortgages. Unfortunately, it seems that the terms of the

mortgages that Delta provides can't be met by quite a number of its borrowers, and many face the loss of their homes. This type of predatory lending practice is extremely harmful to the individuals whose homes are at stake, as well as the communities in which they live. Under the current CRA regulations, Bankers Trust may well seek - and receive - CRA credit for these loans. (See Attachment #4, "Suits Say Unscrupulous Lending Is Taking Homes From the Poor," *The New York Times*, 1/18/99.)

Expectations are that most large financial holding companies would establish woofies to operate in tandem with their insured banks. Since uninsured deposits comprise approximately 23% of all deposits currently held by depository institutions, allowing the formation of this new type of bank could lead to a significant reduction in deposits held by insured banks, and a concommitant shrinking of the insured banking system. To the exent that this shift occurs, and these financial resources flow into institutions governed by less stringent CRA requirements, it could result in cutbacks in commitments on the part of the newly down-sized retail banks for lending and fundamental banking services in underserved areas.

Elimination of Prior Approval Requirements for Cross-Industry Mergers

H.R. 10 repeals the current restrictions on affiliations between banks and other types of financial firms. Section 103 of the bill allows a "financial holding company" to acquire a company engaged in permissable activities without prior approval from the Federal Reserve Board, as long as the resulting combination has assets under $40 billion. It dispenses with any opportunity for regulatory review of these combinations, or for public comment on pending transactions. Under this provision, bank holding companies could qualify to become "financial holding companies" as long as each of their subsidiary banks meets two relatively modest regulatory conditions: they must be well-managed and well-capitalized, and they must have satisfactory or better CRA ratings. Last year's version of the bill had another modest, but significant, standard that would have had to be met: that each depository institution have a demonstrable record of providing low-cost, basic banking services. That standard, proposed by Representative Waters and adopted by the Committee on a voice vote, was one of the very few provisions that would have attempted to insure that low and moderate income people would not be pushed further out of the financial mainstream by this profound industry restructuring. We are very disappointed that it has been stripped out of this year's bill.

Combinations that would result in companies with assets over $40 billion would be subject to a requirement to notify the Federal Reserve Board of the intended merger or acquisition, and the Fed would have a 60 day period, which could be extended to a maximum of 120 days, to disapprove the proposed transaction.

In contrast to this procedure, the Bank Holding Company Act currently requires a formal application and prior Federal Reserve Board approval for acquisitions of companies engaged in either banking or non-banking financial activities. Before approving a requested transaction, the Fed must first determine that the benefits of the acquisition outweigh any possible adverse effects. The public is provided notice of the pending transaction and permitted to submit its views in writing to the Board.

In the case of depository institution acquistions, the Fed has on occasion convened public meetings to obtain more extensive public input on an important merger. For example, last year the Board held hearings on the merger of NationsBank and Bank of America, as well as on the

Citicorp/Travelers merger Hundreds of witnesses testified, an indication of the importance the public places on this process.

We believe that the prior approval and public input process has worked well to surface important issues and enable the regulators to consider important aspects of a transaction that are of deep concern to the general public. The cross-industry mergers permitted by H.R. 10 will have a critical impact on affected markets throughout the nation, and will undoubtedly raise a host of public concerns. This is especially true for small population states that could easily be by-passed as a result of increasing financial concentration within the banking and financial services industries.

Prior approval should be required, as well as notice and adequate opportunity for public comment. We urge that these features be retained and that they be applied to the types of cross-industry mergers permitted by the bill. Further, we urge that the Waters lifeline banking provision adopted by the Committee last year be reinstated.

No Prohibition Against Insurance Companies That Discriminate Owning Banks

The pervasiveness of discriminatory practices that restrict, limit or deny homeowner's insurance in older urban and predominately minority communities has received considerable attention. In 1993, a study by the Association of Community Organizations for Reform Now (ACORN) found that insurance agents are five times more likely to refuse homeowners in low income and minority urban areas than comparable white urban areas. Two years ago, the National Fair Housing Alliance (NFHA) filed a series of discrimination complaints with the U.S. Department of Housing and Urban Development against four major insurance companies following a twenty-four month investigation. These complaints allege that these major insurers engaged in pervasive discriminatory practices. Last October, a jury in Richmond, Virginia unanimously awarded $100.5 million in damages to a local fair housing group, Housing Opportunities Made Equal, in a race discrimination suit it had filed against Nationwide Insurance Co. Nine lawsuits are currently pending against another major insurer by its own white agents, who allege that they were instructed not to write homeowner's insurance in four large cities to limit the company's coverage of African American clients.

At the same time, the lack of effective state regulation to combat redlining and other forms of discrimination is well documented. A *Wall Street Journal* article published last year described how officials of the National Association of Insurance Commissioners (NAIC) were coerced by large insurance companies into suppressing a major study the organization had conducted on insurance redlining practices. (See "How Insurance Firms Beat Back an Effort for Stricter Controls," *Wall Street Journal*, 2/5/98.)

Simple fairness should dictate that insurance companies engaged in discriminatory practices should not be allowed to own banks. However, as the bill stands now, even those companies engaged in flagrant violations of the Fair Housing Act could affiliate with banks that are more carefully monitored for discrimination purposes. We fear that the lack of effective regulation of insurance companies would have negative consequences for fair lending compliance by banks that are controlled by these companies. And to the extent that insurance companies use may their agents to sell bank products, bank examiners will be precluded from access to these agents or evaluation of their practices for fair lending compliance and oversight purposes.

In 1993, the House of Representatives passed legislation that was intended to curb insurance redlining practices. Unfortunately, it was allowed to languish in the Senate. We urge the Committee to reconsider that legislation.

In 1997, the version of H.R. 10 that was voted out of this Committee included a provision that would have barred insurance companies from affiliating with banks if they were found to have discriminated in the sale of insurance after entering into a consent decree. No similar provision is incorporated into this bill -- an omission that should be reversed.

There were several other proposals that were considered by the Committee in the last Congress and rejected, that would represent important steps toward addressing some of the issues I have identified. These include: 1) the amendment offered by Representatives Waters and Kennedy to require that the lending activities of non-banking affiliates of bank holding companies to be considered in determining the CRA record of the holding companies' bank affiliates; 2) the amendment offered by Representatives Waters and Gutierrez to bar a bank holding company from affiliating with a securities firm or insurance company, or a commercial firm, unless all of its subsidiary banks and non-banking affiliates were determined to be meeting community credit and consumer needs; and 3) an amendment offered by Representative Kennedy to require the collection, by census tract, of race/national origin and gender date for insurance policies written by insurance companies affiliated with bank holding companies. I hope that these or similar amendments will be offered again this year, and that they will receive more favorable consideration from the Committee.

Finally, in closing let me say that even if the issues I have raised today are addressed, H.R. 10 poses serious new risks to the taxpayer-backed deposit insurance system that have yet to be adequately addressed. The massive financial conglomerates promoted by this bill will surely be judged by the regulators to be "too big to fail." Although technically non-bank affiliates should be allowed to fail in an economic crunch, we question whether the proposed firewalls will be adquate to withstand the heat. Last year, the Federal Reserve engineered the bailout of a hedge fund that was not affiliated with a bank holding company. What would it do when faced with the imminent failure of an affiliate of a holding company for which it had actual regulatory authority? These issues need much more consideration before this bill is permitted to go forward.

Thank you, Mr. Chairman. That concludes my written testimony.

Attachment 1

September 21, 1998

The Honorable Alphonse D'Amato
United States Senate
Washington DC 20510

Dear Senator D'Amato:

The undersigned organizations are writing to urge your opposition to efforts to schedule time on the Senate floor for HR 10, the "financial modernization" bill reported out by the Senate Banking Committee on September 11. In its present form, HR 10 promotes the formation of giant financial conglomerates, but contains virtually nothing to safeguard access to fundamental banking services for consumers and communities. In fact, this bill is totally opposed by virtually every community leader working to revitalize inner city neighborhoods and rural communities.

HR 10 undermines the effectiveness of the Community Reinvestment Act (CRA), the 1977 law that has served as the primary tool for directing much needed small business, small farm, and affordable housing credit into previously underserved urban and rural communities. The bill passed by the Committee makes it easier for banks to shift their assets to insurance, securities, and other affiliates not covered by the CRA. As a result, banks and thrifts will have fewer resources to lend to underserved geographies.

The Committee took a bad bill and made it worse. It deleted a requirement that banks affiliated with securities firms or insurance companies offer "lifeline" or low-cost checking accounts to low-income customers. The Committee bill also weakens extremely modest CRA provisions that were in the House-passed version of the bill, limiting the extent to which CRA would apply to new, uninsured banks created by the bill, and eliminating enforcement provisions for institutions that fail to sustain an adequate record of serving their local communities.

In short, HR 10 does nothing to modernize the laws that protect the vast majority of consumers and communities that are the most vulnerable to the disinvestment forces that the bill promises to unleash. By promoting the concentration of economic power, this bill will hurt your constituents.

The 809 community organizations signing this letter urge you to voice your opposition to this bill, ask the Senate leadership not to schedule floor time for this harmful legislation, and urge you to work with us to defeat any further consideration of HR 10.

WYOMING

The Honorable Trudy McCraken, Mayor,

NATIONAL

AFL - CIO Housing Investment Trust

Alliance to End Childhood Lead Poisoning

American Planning Association

Center for Community Change

Center for Policy Alternatives

Consumer Federation of America

Corporation for Enterprise Development

Hispanic Association on for Corporate Responsibility (HACR)

Housing Assistance Council

International Brotherhood of Teamsters

International Union of Automobile, Aerospace, and Agriculture Implement Workers / UAW

Lawyer's Committee for Civil Rights

Local Initiatives Support Corporation

NAACP

Ralph Nader

NAHRO

National Alliance to End Homelessness

National American Indian Housing Council

National Association of Affordable Housing Lenders

National Association of Community Action Agencies

National Black Chamber of Commerce

National Coalition for the Homeless

National Community Action Agencies

National Community Reinvestment Coalition

National Congress for Community Economic Development

National Council of La Raza

National Council of State Housing Agencies

National Fair Housing Alliance

National Housing Trust

National League of Cities

National Low Income Housing Coalition

National Neighborhood Coalition

National Neighbors, Inc.

National Organization for Women

National People's Action

National Puerto Rican Coalition

National Trust for Historic Preservation

Neighborhood Reinvestment Corporation

NETWORK: A National Catholic Social Justice Lobby

Rural Housing Coalition

Surface Transportation Policy Project

The Enterprise Foundation

The National Congress of Black Churches

U.S. Catholic Conference

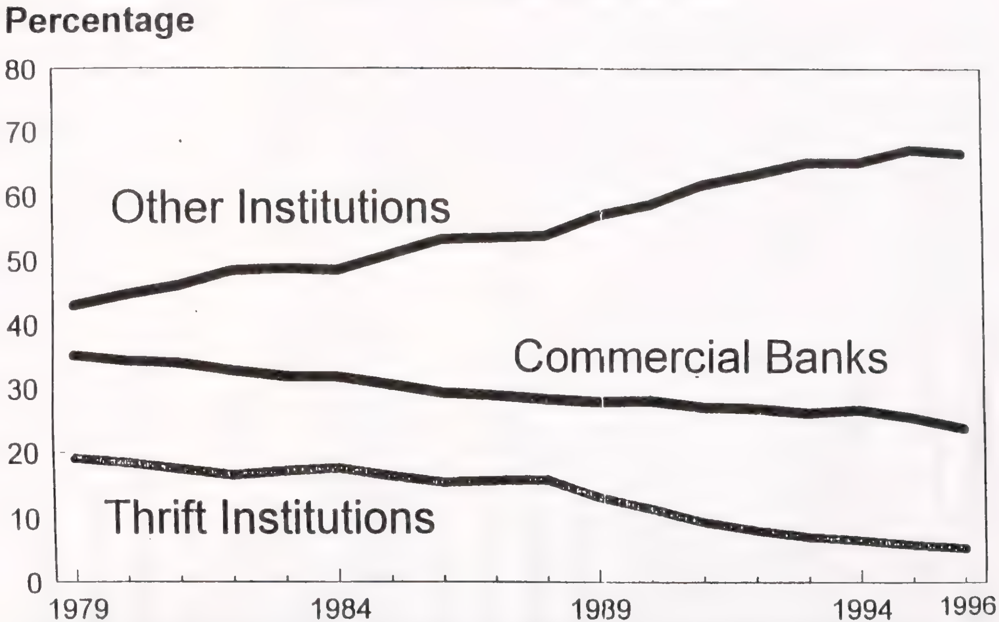
U.S. Conference of Mayors

UNITE

Attachment 2

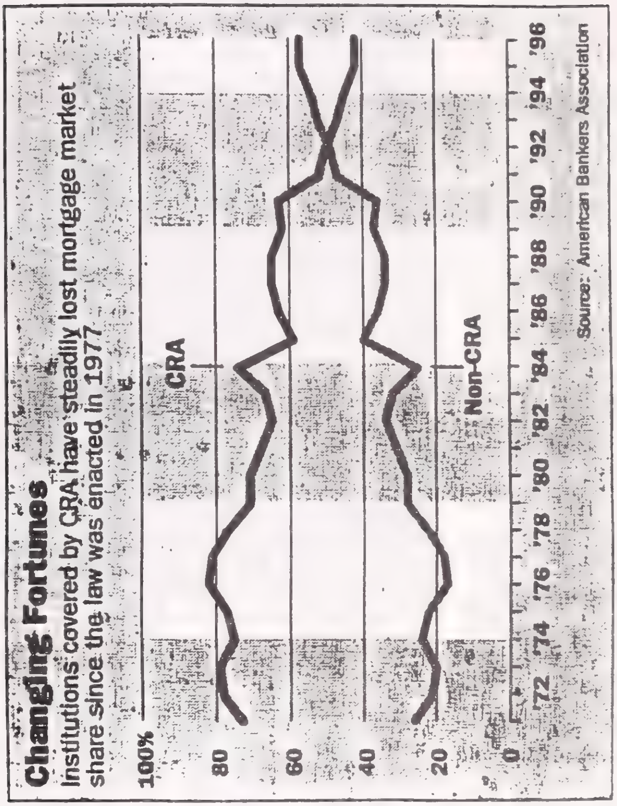
Market Share of Assets

Held by Financial Institutions



Other institutions include credit unions, insurance cos., pensions funds, finance cos., securities brokers and dealers, mortgage cos., and real estate investment trusts.

Source: Flow of Funds Report, Board of Governors of the Federal Reserve System, various years.



Attachment 3

Attachment 4

THE NEW YORK TIMES NEW YORK MONDAY, JANUARY 18, 1999

Suits Say Unscrupulous Lending Is Taking Homes From the Poor

NY Times 1/18/99

By RANDY KENNEDY

By all appearances, the loan agreement Gloria Knight signed in 1995 was a classic transaction between savvy mortgage salesmen and an unsophisticated borrower in a poor Brooklyn neighborhood.

Ms. Knight, a retired teacher, says the salesmen who knocked on her door persuaded her to put her house up as collateral for an $88,000 loan, at 13 percent interest, to help with bills and a previous loan — even though she had no income and no way to make the $973 monthly payments.

But when she defaulted on her loan, leading to eviction notices last year, she ended up in the grip of something far larger than Delta Funding, a relatively obscure Long Island mortgage company that solicits its business from poor homeowners. Delta's partner in trying to take her home is Bankers Trust Company, America's eighth-largest bank.

High-interest lending in poor neighborhoods has long produced high profits for lenders and, often, equally high burdens for homeowners. But the entry of big banks like Bankers Trust is part of a growing trend in such lending and has changed the equation. Over the last several years, Delta has converted hundreds of millions of dollars' worth of its mortgages into securities much like bonds, which it sells to investors through Bankers Trust.

In turn, Bankers Trust has provided Delta with hundreds of millions of investors' dollars, allowing it to make more loans and become a major player in high-interest lending in New York and 21 other states.

But there is a problem: a high percentage of the homeowners can't afford Delta's mortgages. Many say they were duped into taking the loans and now may lose their homes as Delta and Bankers Trust try to reclaim the money for their investors.

Delta and Bankers Trust defend their activities. But Delta's business has recently produced civil lawsuits in three states, and advocates for the poor and social-services agencies say the company has generated more complaints of abusive lending than any other high-interest lender in New York City. They contend that Delta has taken advantage of scores of homeowners and violated Federal and state laws.

Ms Knight, 55, who has since been found to be delusional by a psychiatrist for the city's Protective Services for Adults, cannot even afford electricity. She keeps warm with a kerosene heater and cooks over a makeshift grill in her backyard. But she had something that made her attractive to lenders like Delta: her row house in East New York, which was fully paid for and which served as security. Legal Services lawyers say she will now almost certainly lose it.

Last month, Chief Judge Charles P. Sifton of the Federal Court for the Eastern District of New York stopped the foreclosure sales of homes of three people who defaulted on Delta loans, because, he wrote, the mortgages "on their face" violated Federal law, and so the borrowers showed a good chance of winning their lawsuit.

The homeowners have sued Delta and Bankers Trust, claiming they violated, among other laws, a Federal prohibition on making loans based solely on equity in a house and not on a homeowner's ability to repay. The suit seeks to represent tens of thousands of other Delta borrowers who lawyers say are in similar circumstances.

Officials with Bankers Trust, which is being acquired by the German banking giant Deutsche Bank, declined repeated requests for interviews. On Friday, William McBride, a bank spokesman, said in a statement: "Bankers Trust's sole responsibility in these situations is to safeguard the interests of investors. We have no other connection to these actions."

Marc E. Miller, Delta's general counsel and a son of its founder, vigorously denied that the company engages in deceptive lending, saying it made no sense financially for the company to make loans it knew would fail. "There is sometimes this myth that's spread around that lenders do make money" from foreclosed properties, Mr. Miller said. "And it is a myth."

While refusing to comment on cases that are in litigation, he added that "if a loan simply doesn't make sense for a borrower, we won't do it."

But city real estate records show high foreclosure rates on Delta mortgages in some neighborhoods. In Brooklyn, where the company is most active in the city, a search of records found that 48 of 363 loans made by Delta in 1995 — or about 13 percent — have ended up in default, and Delta has begun foreclosure actions. For 1996 loans, the records show, the figure is 99 of 923 — more than 10 percent.

In its annual report to the Securities and Exchange Commission last year, Delta reported that 4.65 percent of all its loans were in foreclosure, calculated by the dollar amount of the loans

According to Inside B&C Lending, an industry newsletter that reports statistics from several large lenders, about 2.65 percent of the high-risk loans nationwide, by dollar amount, were in foreclosure as of September 1998, the most recent date for which information was available. An additional 1.9 percent were 90 days delinquent and in danger of foreclosure.

Delta's critics contend that the company has devastated the lives of many working-class homeowners, most of them elderly. "These folks not only lose their homes, but lose every dime of equity they have built up, and in most cases this is all they have to show for years of hard work," said Josh Zinner, a lawyer with the Foreclosure Prevention Project for Seniors, a branch of South Brooklyn Legal Services set up last year to pursue claims of abusive lending.

Anna Dawson, a 67-year-old Brooklyn widow who is fighting Delta and Bankers Trust in state court for her home, may get help from prosecutors. The Brooklyn District Attorney's Office is investigating an independent broker who refers business to Delta and who, she contends, falsified her mortgage application without her knowledge to make it appear she could afford a $99,000 mortgage with monthly payments of $1,017.

In reality, her only income was roughly $700 a month in survivor's benefits from her late husband. But her application included a letter saying she was an office manager at United Equities in Brooklyn and a lease that made it appear she rented out a floor of her home. The company does not exist at the address on the letter, and Ms. Dawson said she has not worked in more than two decades. She has no renter. In addition, the signature on the lease is not hers, she said.

Her loan became part of $340 million worth of 1997 Delta mortgages put into a trust managed by Bankers Trust and sold to investors.

In a lawsuit filed in State Supreme Court in Brooklyn, her lawyers contend that the mortgage broker and a home-improvement contractor came to her house uninvited several times, persistently pushing her to get a loan for repairs to her house.

In the end, she was unable to make her payments, and Delta and Bankers Trust have begun to foreclose against her. Meanwhile, she said she was left with almost no proceeds of her loan — after paying Delta's fees, settling a previous low-interest loan and paying the same home-improvement contractor, who she said did little work.

The Growing Trade Of High-Risk Loans

High-interest lending became a big business in low-income neighborhoods nationwide after 1986, when a change in the Federal tax code gave a break to homeowners who took out second mortgages. But complaints about abuses began almost immediately. Unscrupulous finance companies often singled out homeowners, many of them elderly, who had substantial equity in their homes; in case of default, lenders could recoup the loan by taking the home.

In 1993, New York City's Department of Consumer Affairs reported that finance companies, usually working with crooked home-improvement contractors, had "fleeced thousands of lower-income and minority New York City homeowners" out of equity in their homes by tricking them into loans for repairs. The report added that the lenders often researched homeowners before approaching them, studying credit reports to determine whether they had paid off their first mortgage.

Many finance companies resold their mortgages to big banks. But Delta — founded in 1982 in by Sidney A. Miller, a former planner for insurance companies — was one of the first to see a vast untapped resource beyond the banks: the investment market. By converting loans into securities and selling them to investors, finance companies could generate a faster profit and have access to much more capital, and make many more loans

James Estrin/The New York Times

Gloria Knight at her house in Brooklyn, which salesmen persuaded her to put up as collateral for an $88,000 loan. She cooks outside because she has no gas or electricity.

Over the last decade, the market in asset-backed securities like those issued by Delta has grown from $9 billion to more than $140 billion, as investors pursued the rapidly expanding trade in high-risk auto loans, credit cards and home-equity loans. The size of the high-risk home-loan industry alone reached more than $120 billion in loans issued nationwide in 1997, according to industry estimates.

Recently, big lenders like Chase Manhattan, Norwest, Nationsbank, General Electric, Keycorp, Countrywide Credit Industries and others have expanded their involvement in high-interest lending.

Delta began selling loans as securities in 1991, giving investors the right to share in mortgage interest payments, and Bankers Trust's California branch soon began to manage the trusts that held these securities. Delta's business zoomed. In 1994, it made about $100 million in loans. By last year, according to its Federal securities filings, its loans increased to more than $1 billion. It grew from about 150 employees to more than 1,000. In 1996, it went public, on the New York Stock Exchange, and in 1997 it reported profits of more than $30 million.

William J. Brennan, a lawyer for the Atlanta Legal Aid Society who specializes in lending abuse cases and is familiar with lawsuits against Delta, criticizes Bankers Trust as Delta's "enablers."

"Bankers Trust would never make these kinds of loans themselves," he said, "but they put themselves in the position of enhancing the power of Delta Funding to engage in abusive lending. And they do it because there's lots of money to be made."

But in the view of Marc Miller, whose family runs Delta, based in Woodbury, N.Y., "there are many people who want and need a loan and can't get one. From that standpoint we fill a very legitimate niche in the consumer finance field."

An Incompetence Ruling, And Then Default

Gertrude Menzel, an elderly Queens woman who had lived in her two-story row house in Ridgewood since she was a teen-ager, took out an $81,000 Delta mortgage in the summer of 1994, when she was 78. Five years later, Bankers Trust and Delta say Ms. Menzel owes more than $123,000 in principal and interest, and they are trying to take her house.

There is no dispute that Ms. Menzel signed the loan papers. But little else is clear, including her motivation, since the first mortgage on the house was paid off and she appeared to have no debts. Her lawyer said that she was talked into the loan by an acquaintance who had previously taken financial advantage of her and ended up taking the proceeds of her loan for himself.

But questions remain about whether she was competent when she closed the mortgage in Delta's offices. Workers at a Queens center for the elderly, who saw her almost daily, said they noticed memory lapses and confused behavior well before the summer of 1994.

By Thanksgiving, six months after she got the mortgage, she "was wearing house slippers out into the cold and was not taking care of herself," said Thomas Crossman, who ran the Ridgewood Older Adult Center at the time.

In 199[illegible], according to court papers, two psychiatrists hired by the center found symptoms of dementia and memory loss. One reported that she "does not have any knowledge of her assets or income."

By May 1995, Ms. Menzel was ruled legally incompetent in State Supreme Court, and she later defaulted on the mortgage.

But Bankers Trust argued in court papers that her mortgage was valid because Ms. Menzel had not been ruled incompetent before the closing. Partly for that reason, a State Supreme Court judge, Edwin Kassoff, declined to let Ms. Menzel out of the mortgage. Bankers Trust and Delta continue to fight her in court.

Delta's critics say that the company commonly works with aggressive, often unscrupulous mortgage brokers and home-improvement contractors who canvass poor neighborhoods, looking for elderly homeowners willing to put up their homes as collateral for loans to help with bills or home repairs.

A search of court records and Delta loan documents found that at least two people who have referred loans to Delta — John Gizze, the owner of a mortgage consulting firm in Hempstead, N.Y., and Gary Feldman, a Queens home-improvement contractor — have pleaded guilty to conspiracy to commit bank fraud in Federal court in cases unrelated to Delta. Both men admitted in court that they had falsified papers to exaggerate the income of borrowers.

Mr. Gizze's lawyer, Allen Drezin, said Mr. Gizze has subsequently had "some dealings with Delta Funding," but they "have been up to the standards of the industry." Mr. Feldman is now a defendant in a Federal civil suit filed by Mary Lewis, a Queens woman who claims he and Delta deceived her when she took out a home-equity mortgage in 1997.

In a telephone interview, Mr. Feldman said that he has closed few loans with Delta, and denied engaging in any deceptive lending practices in his dealings with the company.

Delta officials said they were unaware of the criminal past of either man, but they added that they do not routinely perform criminal background checks on brokers.

"Dealing with thousands of different brokers," said Mr. Miller, the general counsel, "it would, frankly, be impossible for us to stay on top of every broker at every instant."

The company is now the target of at least four Federal civil suits, three of which seek to represent classes of thousands of homeowners whom lawyers allege were deceived or mistreated by Delta.

The suit filed late last year in Federal District Court for the Eastern District, which includes Brooklyn and Queens, accuses Delta of consistently lending to people based on the equity of their homes and not on their ability to pay, a practice the plain-

tiffs' lawyers say has led to scores of foreclosures

The suit also accuses Delta of breaking Federal law by charging exorbitant extra interest once a loan goes into default. (A review of Delta loan papers for several borrowers found that the interest commonly jumps to 24 percent after default. In New York, interest rates over 25 percent are prohibited by criminal usury laws.)

Delta and Bankers Trust, represented by a single law firm in the case, have not yet responded to the allegations in court

In Mississippi and Georgia, two Federal civil suits allege that Delta is one of many high-interest mortgage lenders paying fees to mortgage brokers, which would violate Federal law. The suits allege that these fees are, in reality, a kickback to brokers for steering borrowers to the lenders, even though it may not be in the borrowers' best interest

Delta officials deny the accusations. But in a similar Federal class-action case in New York, Delta recently settled with the plaintiffs in a confidential agreement, according to reports Delta filed with the Securities and Exchange Commission

Mr. Miller said in a written statement that all such suits contain "accusations, rather than fact" and have been filed "solely for the purpose of delaying or preventing Delta Financial from protecting its rights"

Allegations of Deceit And Finder's Fees

But Delta has not always been successful in challenging claims of abuse. In November 1991, Theresa Leonardi went into the hospital with thyroid and heart problems, only a month after the death of her husband of 50 years. Three days after she was released from the hospital, according to a lawsuit she filed against Delta, she was taken to the lender's offices, then in Great Neck, N.Y., by a stockbroker who later pleaded guilty to mail fraud against her in a separate case and served time in prison

Mrs. Leonardi took out a $95,000 mortgage on her home in Sheepshead Bay, Brooklyn, but she said later in a lawsuit against Delta that she was never told she was signing loan papers and believed she was signing investment papers.

The papers described her as a 68-year-old self-employed investor making $7,000 a month. In fact, she was almost 73 and was living mostly on Social Security.

In giving the loan to Mrs Leonardi, according to court documents, Delta waived its written policy stating that income tax returns should be used to verify the income of loan applicants

In the end, her lawyers say, all her mortgage proceeds went directly to the stockbroker, and Mrs. Leonardi never made a single loan payment. By December 1992, the bank began a foreclosure.

Carl Felsenfeld, a former Citicorp vice president who was an expert witness for Mrs. Leonardi, said in a deposition that the case showed "clear and convincing evidence of Delta's participation in the fraud perpetrated on Mrs. Leonardi."

Delta denied the accusations and pointed out that Mrs Leonardi had chosen the unscrupulous stockbroker herself. "It is a sad commentary on our society," Marie Klasa, a Delta vice president, wrote in a letter in 1995, "that people must seek to blame others for their own errors in judgment."

But as the trial approached last summer, Delta agreed to pay Mrs. Leonardi $200,000 — more than twice the amount of her mortgage — in a confidential settlement in which Delta admitted no wrongdoing

Mr. Miller said the company settled because it believed it would be less costly than pursuing an appeal.

"The actual facts," he said, "are that Delta made a loan that made sense at the time to a woman who knew what she was doing at the time."

Mrs. Leonardi remembered it differently "At no time did any of these people explain to me that I was signing papers for a mortgage on my home," she stated in court documents. "They merely pointed to the lines, and I signed or initialed as directed. At the time I was so weak that I couldn't walk without assistance and could not read any of the papers that I was asked to sign."

Testimony Submitted to the

Banking, Housing and Urban Affairs Committee

Of the U.S. House of Representatives

On the Financial Services Modernization Act

February 19, 1999

Gale Cincotta
Executive Director

I submit this testimony to the Banking Committee of the U.S. House of Representatives to voice my support of the Community Reinvestment Act and my opposition to H.R. 10. I testify not only as executive director of the National Training and Information Center (NTIC), but as chair person of National People's Action (NPA), a nationwide coalition of 302 grassroots neighborhood groups in 38 states. NTIC and NPA work on neighborhood issues such as community reinvestment, anti-crime and -drug strategies, and reform of the Federal Housing Administration. Community groups participating in NPA spearheaded passage of the Community Reinvestment Act (CRA) in 1977 to end redlining and provide access to credit for communities The community members we represent live in neighborhood which were redlined before CRA was passed and will be redlined again if CRA is made obsolete by legislation like H.R. 10.

The so called "financial modernization" bill, H.R. 10, would hurt our neighborhoods by changing the structure of the banking industry and leaving consumer protections in the dust. H.R. 10 would take the community out of the Community Reinvestment Act by eliminating any meaningful opportunity for the community to voice its concerns in the face of bank mega-mergers. The proposed legislation would facilitate the creation of huge financial conglomerates that are not held accountable to communities. "Financial modernization" would make it easier for bank holding companies to avoid current CRA obligations by shifting assets into non-covered affiliates and further shrinking the CRA pie.

The Community Reinvestment Act needs to be strengthened and updated, not weakened and made obsolete by H.R. 10. Every day in the newspapers, Phil Gramm and the Republicans call CRA "extortion" and tell us that banks are being "enslaved" by community groups. The truth is that before CRA, the low- and moderate-income communities we represent were redlined. Banks cut off communities within their service area and denied access to credit to predominantly minority neighborhoods. Since the passage of CRA in 1977, banks have invested over $1 trillion in previously underserved areas and they made a profit doing it. CRA is not a government program or an onerous regulatory requirement. CRA opens up new markets to banks and community groups serve as a marketing tool to assist in the outreach. In one polish neighborhood in Chicago, for instance, a CRA partnership meant hiring polish speaking loan officers that the

bank found through the community group.

CRA is a NPA's most recent victory for community reinvestment happened last July when groups of residents from underserved neighborhoods in Chicago's north, south and west sides came together to support reinvestment during the BancOne-First Chicago merger. The banks and community groups established a reinvestment plan for nearly $4 billion for housing and small business lending. Loan officers will work with community groups to get the loans out to qualified residents. Community groups and the bank are working together in a marketing relationship to increase lending and make it profitable in underserved communities. The NPA-BancOne-First Chicago experience demonstrates CRA's unique ability to open up new markets for banks. This is just one example of how CRA promotes capitalism and a market-based solution to disinvestment.

Regardless of the enormous success of CRA, redlining will return if CRA is neglected. Banks are already finding new ways to avoid existing CRA requirements. Banks are doing more and more of their lending through mortgage company subsidiaries that are not covered by CRA. When CRA was enacted in 1977, insured depository institutions made about 80% of mortgage loans. Today, insured banks make only 42% of mortgage loans. This decline is largely due to the proliferation of bank affiliated mortgage companies and subprime lending companies. In 1992, subprime lenders made 1.4% of mortgage loans, in 1997 they represented 16% of mortgage loans. In our neighborhoods, these mortgage companies are abusive, subprime lenders Predatory lenders push high-interest, high-fee mortgage loans and often lead residents into foreclosure They operate in neighborhoods that traditionally have had poor access to credit We call this trend reverse redlining. Where our neighborhoods faced redlining and disinvestment before CRA was passed, now they are inundated with bad loans from predatory, subprime lenders beyond the scope of CRA. We need to expand CRA to cover the lending activity in our neighborhoods, including mortgage company subsidiaries of insured depository institutions We cannot afford to destroy or diminish CRA. If Republicans like Gramm are interested in identifying extortion, they should look at their own lists of PAC contributors and not in our neighborhoods.

Further, we believe H.R. 10 poses a grave threat to the stability of the nation's economy Repealing the Glass-Steagal Act, as proposed, would allow the concentration of capital in a few financial conglomerates. The bill also eliminates any meaningful prior approval and public input

requirements regarding mergers between banks and insurance. Who will bail out these behemoths if they go under? Destroying Depression-era financial reform invites history to repeat itself.

The creation of Wholesale Financial Institutions ("WFIs" or "woofies) in H.R. 10 is another source of great concern. Wholesale Financial Institutions are banks that only accept deposits above $100,00 and do carry federal depository insurance. While WFIs are not permitted to carry federal insurance, these banks would retain their access to the Federal Reserve Board's discount window. Authorizing the creation of this new type of bank could also significantly reduce the deposits held by insured banks that carry stronger CRA obligations. The creation of uninsured banks sets a bad precedent by threatening to erode our system of federal depository insurance and diminish CRA. While we are pleased that WFIs, in the current legislation, would be covered by CRA, this does not address our fundamental concern about WFIs -- their impact on CRA and the system of federal depository insurance. Again, we ask, who will bail out these uninsured banks if they go under? If H.R. 10 passes, taxpayers like us will. As experience has shown us, no bank is truly too big to fail.

We urge members of Congress to vote no on H.R. 10 and any other legislation that is detrimental to community reinvestment.

APPENDIX

February 12, 1999

CURRENCY

Committee on Banking and Financial Services

James A. Leach, Chairman

For Immediate Release:
Friday, February 12, 1999

Contact: David Runkel
(202) 226-0471

Opening Statement
Of Rep. James A. Leach
Chairman, House Banking and Financial Services
Third Day, Hearings on H.R. 10

Today we will hear from Treasury Secretary Robert Rubin and a distinguished panel of federal bank regulators. Before turning to Secretary Rubin, however, I would just like to note that this set of hearings has produced remarkable agreement on the need to move forward with financial modernization legislation.

I was struck Wednesday by the degree of acceptance of the construct of H.R. 10. The industry support – from the banks, securities firms and insurance interests – is stronger than even that given last fall. There has been growing belief within the financial sector of the economy that we should proceed and proceed quickly on this legislation.

In addition, the words of the Ranking Minority Member, Mr. LaFalce, and Secretary Rubin at their news conference Wednesday are indicative of the bipartisan nature of support for legislation this session which I sincerely welcome.

Because of the growing consensus on this issue, I have decided to move ahead with a mark up of H.R. 10 earlier than I had originally intended, and will be scheduling the bill for Committee consideration on x,x and x.

We will be sending out official notification next week.

Secretary Rubin.

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR RELEASE UPON DELIVERY
Expected at 10:30 a.m. MST
January 16, 1984

Testimony

of the

Honorable Donald T. Regan

Secretary of the Treasury

before the

Senate Committee on Banking, Housing and Urban Affairs

Mr. Chairman and members of this distinguished Committee:

It is a pleasure to have an opportunity once again to present the Administration's views on the financial reform proposals now pending before Congress.

More than anyone else, Mr. Chairman, you are to be commended for your timely response to the legitimate demands for restructuring the Nation's financial marketplace. In 1982 you, in cooperation with Congressman St Germain, were responsible for the achievement of landmark financial reform legislation -- the "Garn-St Germain Depository Institutions Act of 1982". Your current omnibus legislation -- the "Financial Services Competitive Equity Act" (FSCEA, S. 2181) -- represents another comprehensive and ambitious proposal, the enactment of which would benefit significantly the consumers, as well as the providers, of financial services. You and your Committee are to be congratulated for your efforts.

PREFACE

I would like to limit my remarks today to an overview of the issues we believe are most significant and the principal differences between pending proposals and the Administration's Financial Institutions Deregulation Act (FIDA, S. 1609). At a later date I understand we will be given an opportunity to present our views in greater detail.

Recent years also have witnessed certain developments that are progressively minimizing the traditional distinctions between banking and nonbanking services. Diversified nonbanking firms such as Sears-Roebuck, Merrill Lynch, Shearson/American Express, and Prudential-Bache are rapidly approaching the point where they can offer one-stop financial shopping. Of critical importance to the diversification plans of many of the non-regulated financial institutions has been the acquisition of a depository institution. The emphasis in this respect has been on the so-called nonbank bank -- a source of insured deposit funds with direct access to the payments mechanism.

Finally, a progressively more sophisticated consumer is demanding, and expects to receive, major benefits from a more innovative and responsive financial services marketplace. Only as more firms are able to offer consumers a wide variety of financial products at competitively lower prices and greater convenience will the new needs of consumers be satisfied.

All of these institutional and consumer "initiatives" have tended to destabilize somewhat our financial marketplace, and in some cases have stimulated state legislatures and Federal regulators to take their own, often uncoordinated, measures to deregulate the financial services industry. Without action by Congress this type of chaos will become commonplace and, ultimately, interests will be put in place that will make comprehensive and balanced reform next to impossible.

IMPORTANCE OF THE HOLDING COMPANY REQUIREMENT

I am particularly pleased that both S. 2181 and S. 2134 would adopt the holding company approach the Administration has been advocating for several years and has embodied in its current FIDA proposal. All three of these bills would require nonbank or non-thrift activities to be performed through a holding company or its nondepository affiliates and not in the depository institution itself. There are several reasons why the Administration believes strongly that the holding company structure is the only acceptable means of expanding nonbanking activities.

Banks and thrifts are unique financial intermediaries affected with a public interest. As such, they are Federally-supervised, have access to a Federal lender of last resort, and have some portion of their deposits Federally insured. The Administration does not believe that these institutions should directly engage in new and risky activities that cannot be regulated effectively by a single bank regulatory agency. This would place an inappropriate supervisory and insurance burden on the Federal Government. Moreover, the unique status of depository institutions enables

them to raise money in the private financial markets at a lower cost than most other borrowers by allowing the payment of lower explicit returns and/or by enabling them to overcome more easily the caution of potential investors in placing their funds with the institutions. These institutions should not be able to use the lower cost funds to engage directly in activities with non-depository institution competitors or to capitalize direct subsidiaries at advantageous transfer costs.

The Administration, in addition, does not believe that non-depository institution activities should be conducted through a subsidiary or service corporation in which a bank or thrift has a direct equity investment. Again, the investment would be at risk if the subsidiary's activities were to falter, and the funds for the investment would be raised with Federal assistance not available to non-depository institution competitors and at a cost advantage to the bank or thrift. In addition to permitting equivalent regulation of functionally equivalent activities, the adoption of the holding company approach as the underlying principle of depository institution deregulation would remove many of the inconsistencies and anomalies that currently confuse the issue of bank deregulation.

DIFFERENCES BETWEEN THE "FINANCIAL SERVICES COMPETITIVE EQUITY ACT" AND FIDA

Title I of S. 2181 is based on the Administration's FIDA proposal. Its major provisions would substantially deregulate the range of financial services that can be offered by depository institution holding companies largely along the lines of FIDA. We fully support the expansion of holding company activities provided in this bill.

Even though Title I is based on the Administration's holding company model, there are a number of important differences. The more significant of these differences involve (1) an exception from bank holding company regulation for a "consumer bank", (2) an exemption from activities restrictions for a unitary savings and loan holding company the subsidiary of which is a "qualified thrift lender", (3) a limitation on the size of combinations of holding companies and other financial intermediaries, (4) a limitation on branching and interstate acquisitions, and (5) more stringent anti-tying provisions.

Consumer Banks. FIDA defines "bank" for purposes of the BHCA to include (1) any FDIC-insured bank, (2) any institution eligible for FDIC insurance, and (3) any institution that both accepts demand deposits that the depositor may withdraw by check

TREASURY NEWS
Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR RELEASE UPON DELIVERY
Expected at 10:00 a.m.
July 18, 1983

Testimony of the Honorable Donald T. Regan
Secretary of the Treasury
Before the
Senate Committee on Banking, Housing and Urban Affairs

Mr. Chairman and members of this distinguished Committee:

I appreciate this opportunity to present the Administration's proposal to deregulate the activities of depository institution holding companies.

INTRODUCTION

Last year we introduced a proposal for bank holding company deregulation, in conjunction with a proposal to deregulate the lending and investment powers of thrift institutions. The thrift industry proposals constituted the major elements of the Garn-St Germain Depository Institutions Act of 1982, which the President signed into law in October. However, Congress decided not to deal with bank holding company deregulation at that time. The President, in signing the Garn-St Germain Act, therefore called for prompt action this year to enact the Administration's bank holding company deregulation proposal.

During the first half of 1983 this Committee has held extensive hearings on the need for additional financial system reform. I am pleased, Mr. Chairman, as a part of this process, to reintroduce our holding company legislation, entitled the Financial Institutions Deregulation Act (S. 1609). It differs from last year's proposal in two major respects. The current version provides a comprehensive framework for expanding the financial service powers of thrift institutions as well as commercial banks. In addition, it modifies the supervisory responsibilities of the Federal Reserve Board.

The Administration opposes a moratorium because, if accepted, it could remove all pressure for reform and likely be extended from year to year. Meanwhile, firms that already have entered new markets would become more entrenched, making it more difficult for Congress to have any constructive impact on the industry, and making subsequent entry by new firms more difficult when the moratorium is finally lifted. Therefore we have introduced our Financial Institutions Deregulation Act at this time so that Congress can act on legislation that will have a positive deregulatory effect on the financial system by maximizing the competitive benefits for all participants, particularly consumers, and by removing distortions in the current scheme of regulation.

The bill is designed to "chill" engagement in new activities after July 1, 1983 by providing that upon its effective date, bank and thrift holding companies would have to conform these new activities to the bill or divest their bank or thrift subsidiaries.

PRINCIPAL FEATURES OF THE PROPOSED LEGISLATION

The current bill follows the conceptual framework of last year's bill (the Bank Holding Company Deregulation Act of 1982) in that it permits banks to engage in certain new activities through holding company affiliates but not directly through the bank or its subsidiaries. The new bill expands upon that concept to provide parallel treatment of bank and thrift holding companies by establishing the same authorizations and limitations for each of their activities.

Scope of the Bank Holding Company Act

The bill broadens the scope of the Bank Holding Company Act to apply to any company that controls a Federally-insured bank, an institution eligible to become a Federally-insured bank, or an institution that both accepts deposits that may be withdrawn on demand and makes commercial loans. This change brings Federally-insured nonbank banks, as well as non-Federally-insured state chartered banks and thrift institutions, under the jurisdiction of the Bank Holding Company Act.

New Activities

The bill would permit bank or thrift holding companies to engage, directly or through holding company subsidiaries, in the following activities:

-- dealing in and underwriting municipal revenue bonds and some tax-exempt industrial development bonds;

-- sponsoring and managing investment companies and distributing their securities;

-- insurance underwriting and brokerage;

-- real estate investment, development, and brokerage, subject to a 5% capital limitation on real estate investment and development;

-- activities the Federal Reserve Board determines to be "of a financial nature" or closely related to banking;

-- owning both a thrift and a bank; and

-- all activities currently permitted by law or regulation for bank holding companies and multiple savings and loan holding companies.

The bill requires the Federal Reserve Board, within 180 days after the effective date of the act, to promulgate regulations listing and describing specific activities that are of a financial nature and activities that are closely related to banking. In defining activities of a financial nature, the Board is directed to "promote competition between bank holding companies and all other companies engaged in activities of a financial nature or closely related to banking." The Board has the right to prescribe limitations on these activities consistent with stated criteria and with safe and sound financial practices.

In the securities area, certain activities would have to be conducted through a securities subsidiary of the holding company or through the holding company itself, as would all securities brokerage, underwriting, and dealing activities that are now authorized for banks. However, if a bank or thrift holding company or its nondepository institution subsidiary did not engage in the new specified securities activities or discontinued those activities, it could continue to conduct currently authorized securities underwriting or dealing activities within its bank or thrift or their subsidiaries.

IMPORTANCE OF THE HOLDING COMPANY REQUIREMENT

A key element of the bill is the requirement that nonbank and nonthrift activities be performed through a holding company for several reasons.

First, banks and thrifts are unique financial intermediaries affected with a public interest. As such, they are Federally-supervised, have access to a Federal lender of last resort, and have some portion of their deposits Federally-insured. The Administration does not believe that they should directly engage in new and risky activities that cannot be regulated effectively by a depository institution regulatory agency. This would place an inappropriate supervisory and insurance burden on the Federal government.

Second, the unique status of depository institutions enables them to raise money in the private financial markets at a lower cost than most other borrowers. The relative safety of funds deposited with the institutions permits them to pay slightly less for the large volumes of money they raise than other firms pay for their borrowings. In addition, demand deposits, which have no explicit interest rate, make up a significant portion of depository institution resources, especially for banks. The institutions should not be able to use the lower cost funds to directly engage in activities with non-depository institution competitors. Nor should they be able to use these funds to capitalize direct subsidiaries at advantageous transfer costs (equity prices) which will give a direct subsidiary capital costs lower than those of independent competitors. This is especially true since independent firms other than the very largest raise most of their short-term funds through some form of borrowing from a depository institution. Inherently this borrowing will be at a mark up over the institution's melded cost of funds.

Although the bill does not directly address tax issues, it will advance the equal tax treatment of all competitors involved in conducting municipal finance activities. Banks currently can deduct 85 percent of interest paid on deposits as an expense of purchasing or carrying tax exempt securities, but nonbank dealers generally are prohibited from deducting interest they pay on debt incurred to buy tax-exempt obligations. By requiring banks to conduct municipal securities activities in holding company affiliates, the bill would place bank and nonbank organizations on the same footing in this respect.

The Administration also does not believe that non-depository institution activities should be conducted through a subsidiary or service corporation in which a bank or thrift has a direct equity investment. The investment would be at risk if the subsidiary's activities were to falter, and the funds for the investment would be raised with Federal assistance not available to non-depository institution competitors and at a cost advantage to the bank or thrift. Notwithstanding this belief, the

Administration bill would authorize mutual thrifts to engage through service corporations in more extensive activities since only equity savings and loans can be owned by holding companies and, thus, mutual savings and loans could not take advantage of the holding company form of organization.

Third, the holding company approach permits equivalent regulation of functionally equivalent activities but without imposing additional or duplicative regulation on these activities. Under our bill, all subsidiaries of bank and thrift holding companies would be subject to regulatory supervision appropriate to the subsidiary's line of business. For example, insurance and real estate activities would continue to be primarily regulated by state agencies. Securities subsidiaries would be regulated as broker-dealers or investment advisers by the Securities and Exchange Commission and state securities regulators, and also may be members of securities industry self-regulatory organizations and the Securities Investor Protection Corporation. By requiring new and existing securities activities to be performed in holding company affiliates, the bill in effect removes securities activities from primary supervision by bank and thrift regulatory agencies, thereby avoiding multiple layers of regulation. Thus, the framework would permit a wide variety of financial organizations with different regulatory regimes to be included under the holding company umbrella in a manner that maximizes competitive equality with independent firms without imposing more regulation on their activities.

Finally, if Congress were to adopt the holding company approach as the underlying principle of depository institution deregulation, many of the inconsistencies and anomalies that currently confuse the issue of bank deregulation would be resolved. National banks, state-chartered member and Federally-insured member banks, stock savings banks, and stock savings and loans would be able to associate themselves through holding companies with a broader range of financial services and thus would have access to a broader spectrum of customers than their limited activities currently permit. Financial service firms would be able to acquire or charter banks and thus, to offer their customers the unique services that banks can provide; controversy over nonbank banks and unequal regulatory treatment of different categories of depository institutions would disappear.

Simplified Holding Company Formation

Currently banks and thrifts that want to reorganize as holding companies must first go through an expensive and time consuming process of obtaining regulatory approval. The

favorable funding and possible tax advantages and would avoid potential conflicts of interests. See id.

Under S. 2851, the Board remained umbrella supervisor for bank holding companies, and a bank holding company could engage in the newly permitted securities activities only after giving prior notice to the Board. Any DISA also was required to register as a broker-dealer with the Securities and Exchange Commission ("SEC") and was made subject to regulation and supervision by the SEC.

II. S. 1886, 100th Congress, 2d Session (1988)

After 14 days of hearings on financial modernization, on March 2, 1988, the Senate Banking Committee for the 100th Congress marked up another bill to modernize regulation of financial services. S. 1886, entitled the "Proxmire Financial Modernization Act of 1988," authorized more extensive securities activities for banking organizations than had been permitted by S. 2851 in the 98th Congress. S. 1886 was reported to the Senate and within the same month, on March 30, 1998, the bill passed the full Senate by a resounding 94-2 margin. The House Banking Committee also approved revision of Glass-Steagall restrictions, but the full House took no action.

S. 1886 repealed sections 20 and 32 of the Glass-Steagall Act and authorized affiliations between banks and securities companies, which were permitted to underwrite, distribute, and deal in most types of securities, including shares of mutual funds and corporate debt securities. Permission for securities affiliates of banks to underwrite, distribute and deal in corporate equity securities was made contingent on a separate Congressional action, to be taken no later than April 1991. S. 1886 did not authorize the mixing of banking and commerce.

S. 1886, like S. 2851 in the 98th Congress, built on the framework of the Bank Holding Company Act: securities underwriting and dealing activities were required to be conducted through a separately incorporated nonbank subsidiary of a bank holding company that was "carefully insulated" from the bank. S. Rep. No. 305, 100th Cong., 2d Sess. 15-16 (1988). The Senate specifically prohibited any affiliations between FDIC-insured banks and securities companies other than through the holding company structure because,

as noted in the Banking Committee Report, conducting such activities through holding company affiliates "is a much sounder alternative" than engaging in the activities through subsidiaries of a bank. In addition, the Report noted that the Secretary of Treasury, as well as several academic observers, emphatically supported the use of the holding company framework as "the only acceptable means of expanding nonbanking activities." Id. at 15-16, 21 (emphasis added).

The bill retained the Board's role as umbrella supervisor of bank holding companies, and it mandated that bank holding companies obtain Board approval under section 4 of the Bank Holding Company Act prior to acquiring or forming a securities affiliate. S. 1886 also made the securities affiliate subject to functional regulation by the SEC.

The Proxmire Financial Modernization Act generally retained the prohibition on bank holding companies engaging in insurance activities, and it limited national banks to acting as principal, agent, or broker for credit life insurance. Finally, S. 1886 allowed state bank subsidiaries of bank holding companies, and subsidiaries of such state banks, that are located in the same "home" state as the parent holding company to underwrite and broker insurance products if (1) such activity is authorized by state law, and (2) the insurance products are provided only to natural persons within the "home" state.

III. S. 543, 102d Congress, 1st Session (1991)

Like the Proxmire Financial Modernization Act, S. 543 in the 102d Congress repealed sections 20 and 32 of the Glass-Steagall Act and allowed banking organizations to affiliate with securities firms. S. 543 was reported out of the Senate Banking Committee on August 2, 1991, after a series of 22 hearings on financial modernization issues. This bill, entitled the "Comprehensive Deposit Insurance Reform and Taxpayer Protection Act of 1991," was eventually enacted as the Federal Deposit Insurance Corporation Improvement Act of 1991 (commonly known as "FDICIA"), a law that considerably strengthened the supervisory and enforcement authority of the federal banking agencies but did not restructure the financial services industry as the Senate Banking Committee had originally envisioned.

As reported out of the Senate Banking Committee, S. 543 permitted banks and securities firms to affiliate through holding companies in a manner

Statement of Congresswoman Sue Kelly Hearing on Financial Services Modernization Friday, February 12, 1998

Mr. Chairman, Ranking Member LaFalce. I am disappointed that I was unable to personally join you today on this, the third day of hearings on Financial Services Modernization. This issue is one of my highest priorities this year. I was given the opportunity to observe the Paris peace talks for the end of violence in Kosovo this weekend and had to leave on Thursday night. The violence in Kosovo must come to an end and I must do everything in my power to assist this process.

I will do everything I can to ensure that H.R. 10 is enacted in this Congress. I hope that by submitting the attached questions to our witnesses today I can gain a better understanding of the concerns that Secretary Rubin currently holds on H.R. 10, especially the operating subsidiary language. I want to thank our witnesses in advance for their response to my questions and for taking the time out of their busy schedules to assist us in proper consideration of H.R. 10.

(Vol. 72, No. 2)

Viewpoint

Banking Structure

During the recent debate over financial law modernization, legislative and regulatory players argued that concerns with subsidies to insured depositories should guide certain legislative decisions. In brief, the argument went that banks receive a subsidy from the federal safety net and such a subsidy provides an advantage to the bank. The bank in turn could transmit this advantage to its operating subsidiary, which would enjoy a competitive advantage over nonbank firms offering the same products. Therefore, the use of bank subsidiaries should be limited, the argument concludes.

Alfred Pollard argues in this "viewpoint" that, simply put, the argument represents a series of myths.

Exploding the Subsidy Myth

By Alfred Pollard

Supporters of the subsidy world view of banking argue the supposed subsidy derives from three key components of the federal safety net for insured depositories—deposit insurance from the Federal Deposit Insurance Corporation, access to the discount window, and access to the payments system at the Federal Reserve Board.

These three resources, provided by the federal government, constitute the subsidy, proponents say. Attempts to quantify the nature and amount of a subsidy have not received favorable reviews. General estimates of the amount of the subsidy from these three factors range from 10 basis points to 16 basis points.[1]

Assume that such a subsidy exists.

Subsidy Myths. But already the argument hits a snag. Proponents of the subsidy argument quickly turn to its transmission to affiliates or subsidiaries, but they have skipped a key point. What they advance represents a gross subsidy. In short, the abbreviated argument is flawed for not breaking down discussion of subsidies into "gross" and "net" components. An institution may enjoy a gross subsidy, for example, an insurance company's backing by a guaranty fund. However, that view is incomplete. Offsetting costs that accompany such a subsidy, including premiums that firms must pay to guaranty funds, also must factor in the calculation. Once costs enter a calculation and are subtracted from the gross subsidy, then one finds the net subsidy.

Now—to restate the argument—assume a gross subsidy exists.

Most calculations of the costs associated with insured depository status—special business limitations (including asset configuration, reserve ratios, product line limitations), accounting rules, regulatory recordkeeping and reporting, examination and other fees and costs, and so on—constitute a range of expenses between 24.5 to 49.5 basis points.[2]

To be honest, no study has conclusively calculated the gross and net subsidy, but with the ranges set forth above, a strong argument exists that a negative figure would describe the net subsidy, with costs to banks vastly exceeding and offsetting any gross subsidy benefits.

The Fourth Mythical Subsidy Component. One then turns to another argument not frequently discussed, but very much on the mind of those supporting the subsidy myth. The argument goes that financial institutions get support beyond the explicit federal safety net—an inchoate, intangible subsidy exists stemming from the federal government's perceived willingness to support financial institutions in a crisis. In other words, in an argument tied to the "too big to fail" doctrine, markets know that banks will receive extraordinary federal assistance in a crisis and therefore price services to banks tied to this "subsidy."

The argument goes that even if a calculation of gross subsidy offset by regulatory costs may not result in figures supporting a net bank subsidy, still an immeasurable subsidy exists that banks cannot refute, and that

Alfred Pollard is the senior director for legislative affairs at The Bankers Roundtable in Washington, D.C.

policymakers should consider such a subsidy in determining where to locate new business lines.

Two realities undercut the argument.

The first is market behavior. Markets do not appear very focused on some inchoate, crisis-related assistance for banks in their dealings with these firms. If assistance flows to banks in a crisis, what occurs during the next 10 years? In other words, is there evidence of differential market treatment, based on the alleged subsidy, during the period between crises? No convincing arguments have emerged to demonstrate that, in financing banks, markets provide a lower lending or financing rate to banks than to other parties during "non-crisis" times.[3] While one might argue an inchoate tie to the government exists and that some unusual government action might occur in a crisis, market participants do not appear to price their products based on such a concept.

The second reality is that there are limits on the "too big to fail" approach. The market understands that "too big to fail" policies and inchoate subsidies simply have diminished to the point of non-existence or irrelevance. Indeed, concrete evidence runs to the contrary of such a doctrine or subsidy. Markets witnessed federal laws in 1989 and 1991 limit any "too big to fail" doctrine through least cost resolution, early intervention rules, and a specific prohibition on the use of the discount window by banks in a troubled condition.[4] Should extraordinary measures be taken by the FDIC, the costs to the FDIC fall upon the entire banking industry for recoupment, not upon the FDIC or the government.

In addition, markets have seen banks fail and their shareholders and managements lose their economic positions; thrifts in the 1987-1991 time frame and banks in the 1990-1992 time frame demonstrated this reality.

Further, markets recognize that in the most recent financial crises, while concern existed for banks, a greater concern existed for securities firms. While banks might face earnings losses in stock market downturns, such as in 1987 and 1994, securities firms faced severe liquidity problems. The Federal Reserve acted not to prop up banks, but rather to assist a troubled market consisting of securities firms, insurance companies, and banks. In other words, any special government assistance in a crisis appears to flow to intertwined financial players, not to banks alone. Indeed, the law that narrowed bank access to the discount window in troubled circumstances at the same time expanded nonbank access to the discount window.[5]

Finally, mergers among banks reflect a much lower tolerance by markets of weak bank performance. In other words, markets have established their own "too weak to survive" measure that prompts many bank mergers. Banks that meet high regulatory standards, nowhere near any triggers for regulatory intervention, nevertheless find themselves merger or acquisition targets where markets determine that their success will not exceed market expectations.

The level of success as much as the level of failure faces tough market scrutiny today. Some inchoate government bailout simply does not predominate market views of or behavior regarding banking institutions.

The Subsidy and the Subsidiary. Banks enjoy no net subsidy and, as such, have nothing to pass along to subsidiaries.

Even if such a subsidy existed, its transmission to a bank operating subsidiary would face major obstacles.

Operating subsidiary characteristics include a separate corporate identity (including general corporate law limits on piercing the corporate veil to seek recovery from a corporate parent), federal statutory and regulatory limits on business activities and on relationships with a parent or affiliates, separately regulated entities frequently with additional regulatory oversights and costs and federal authority to review and examine (a form of dual regulation).

No subsidy exists in these subsidiaries or flows to them from parent banks.

Experience demonstrates this reality. For example, unitary thrift holding company subsidiaries have not enjoyed a market advantage over other players with many elements of the same safety net available to banks. Ford Motor Co. owned a thrift that neither drove other thrifts or banks out of business, nor did it enhance Ford's competition with General Motors. Further, rating agencies and market analysts evaluate each company on its own, without reference to its parent company; indeed, the fear of bank regulation and drawing on bank subsidiary resources to assist a troubled bank may lower the evaluation of a bank-owned subsidiary.

The myth of a bank-transmitted subsidy fails at the bank level, where no net subsidy exists, and clearly fails when additional regulatory burdens and safeguards enter the equation when looking to a subordinate company.

Additional Doses of Reality. While the discussion above focuses on arguments that involve measurement of costs, anecdotal evidence underscores the fundamental myth of arguments asserting banks or their operating subsidiaries receive subsidies.

First, the supposedly favored bank charter has not prompted large-scale charter changes by nonbanking firms. Affiliation with banks—rather than becoming a bank, with full bank regulation—has emerged as a priority for nonbanks. Apparently, any subsidy that exists has not made the bank charter very enticing.

Second, as noted earlier, markets actually impose greater pressure than regulators. The "too big to fail" concept has been undermined by federal legislation and agency practices. Where the 1991 banking law set triggers for regulatory intervention with troubled banks, the market acts long before such problems emerge, reflected in acquisition of healthy banks that do not meet market performance targets. (This reality supports those who favor increased use of market measures in overall federal regulation of banking.)

Third, "subsidized" banks haven't driven other parties engaged in the same businesses out of their market positions. Banks offer mutual funds, securities businesses, insurance agency, technology and data services, job employment services, tax counseling, and a large laundry list in direct competition with unregulated parties. The market has accommodated bank and nonbank competition and banks have not taken over any of these markets as would be expected from a favorable, meaningful subsidy. Indeed, going further, nonbanks have found enough incentives to offer bank-like products and to be successful in the face of a purported bank subsidy. Nonbanks offer forms of deposit services, bill payment, IRA products and other services. As a result, one may conclude that a subsidy either doesn't exist or

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does so at a level so low as not to have competitive significance or relevant impact.

Finally, why one firm does better over time than another involves many variables, with a subsidy seldom providing the key factor. Attempting to explain advantages of one firm or another—one insurance firm over another, one securities firm over another—as well as between industries may relate more clearly to management strength, geographic focus, customer demographics, capital base, type of market competitors, local regulation, and so on. None of these relates to a subsidy. Further, other industries have government ties, such as SIPC insurance offered at securities firms and guaranty funds backing insurers. Banks with ties to the government have seen market share erode, not increase, and this says much about the impact of any alleged or gross subsidy. For the most part, discussion of subsidies goes more to seeking competitive cover; limits on bank operating subsidiaries would not remedy a competitive advantage, but rather create new competitive advantage not now existing for bank competitors. Under the guise of "reining in" one firm with new regulation to offset a subsidy, competitors really seek to limit competition from that firm.

Closing Comment. Lacking any real subsidy argument, those who oppose bank subsidiaries engaging in more nonbank businesses move to safety and soundness concerns. However, a large body of federal regulation and the lack of concern for (indeed, positive endorsement of) bank subsidiaries by the FDIC fells this argument.

Then, a fear of banks opting for bank subsidiaries over holding company affiliates emerges as an argument, a concern rejected by the fact that banks locate businesses today for business reasons in the bank, in an operating subsidiary or in a holding company affiliate.

Finally, the argument comes forth that there must exist some secret benefit or banks would not fight so hard to maintain the operating subsidiary option. While no secret advantage exists for banks—banks employ operating subsidiaries for diverse business reasons—the use of diverse business structures may ameliorate risk and provide for regulation from more than one source, avoiding concentration of regulatory authority.

In sum, a gross subsidy exists, no net subsidy exists, no subsidy transmission occurs between banks and operating subsidiaries, bank subsidiaries afford businesses diversity and greater strength to banks while not displacing holding company affiliates—these represent realities, not myths.

No real argument exists against bank use of operating subsidiaries.

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[1] See summary of estimates on gross subsidy in The Bankers Roundtable, *The Federal Safety Net—Subsidy Effects In and Outside Banks* (May 1997), pp. 7-11.

[2] Id., at 13-15.

[3] An understanding of lending and financing practices reveals that any cost savings enjoyed by banks result less from a perceived subsidy, than from the reality that in a bank a lender or investor finds an institution that is heavily regulated, thoroughly examined and operating under limitations on the type of investments made and under requirements on the quality of assets held.

[4] Federal Deposit Insurance Corporation Improvement Act amended Sections 10 (a) and (b) of the Federal Reserve Act to limit advances to certain undercapitalized firms (12 USC 347b).

[5] Federal Deposit Insurance Corporation Improvement Act amended Section 13 of the Federal Reserve Act to facilitate securities firm access to the discount window by easing eligibility rules for securities used to secure advances (12 USC 343).

THE BANKERS ROUNDTABLE

The Federal Safety Net—
Subsidy Effects In and Outside of Banks

Occasional Paper No. 3
May 1997

Third in a series of Occasional Papers on issues related to Financial Modernization and Bank Regulation

Federal Safety Net--
Subsidy Effects In and Outside of Banks

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Executive Summary

In discussions about modernizing the laws that govern the financial marketplace, the argument has been advanced that banks and affiliated companies enjoy subsidy benefits from the federal safety net.

This subsidy may be defined as a benefit from the government which results in a distortion in the marketplace, including a competitive, economic advantage for banks. The core elements of the federal safety net are deposit insurance, access to the Federal Reserve payments system and the availability of borrowings at the Federal Reserve discount window.

Measuring such a subsidy has proven very difficult, particularly in light of changing market conditions and bank costs over time. Nonetheless, a tangible, measurable subsidy from the federal safety net-- a gross subsidy-- is in evidence, although estimates of its magnitude vary. The gross subsidy also has diminished in light of legal changes and it is more than offset by regulatory costs associated with the safety net. Taking these costs into account, a net minus subsidy results.

As for an intangible subsidy, anecdotal, marketplace evidence is inconsistent with the existence of a subsidy, particularly in light of legal changes occurring in 1989, 1991 and 1993.

Even if a net subsidy could be demonstrated in a bank, no benefits of such a subsidy would be conveyed to affiliated firms. Legal restrictions on banks, including calls on holding companies for financial support, are understood in the marketplace to limit the value of the relationship to a bank. The market experience of bank affiliated firms demonstrates no subsidy transfers.

The federal safety net continues to provide certainty for insured depositors and stability for financial markets. It has little if any effect on banks as competitors, an outcome that can be demonstrated. The safety net subsidy or its transfer should not be a major issue for financial modernization.

Federal Safety Net--
Subsidy Effects In and Outside of Banks

I. Introduction

Modernization of the federal laws governing financial services raises a number of important policy issues for business, the Congress, the Administration and the regulatory agencies.

Both within and outside the government, concerns have been expressed about allowing banking organizations to expand product and to affiliate with commercial enterprises. Various points have been raised about bank structures, bank safeguards and bank regulation. Recently, arguments have centered on the subsidy banks are supposed to enjoy over nonbanks because of the federal "safety net." The argument contends that, because of a subsidy, banking organizations should not be permitted to offer new products or to affiliate with nonbanking firms, including those with some degree of commercial activities. Alternatively, the argument goes that banks should be permitted such new activities or affiliations, but subject to additional requirements that limit any benefit of the safety net from flowing to their subsidiaries or affiliates to the disadvantage of competitors.

The elements of the federal safety net are considered to be deposit insurance, availability of the Federal Reserve discount window and access to the Federal Reserve's payment system. Each is seen providing a subsidy to banks which they enjoy to their own advantage and to the advantage of their subsidiaries or affiliates.

Occasional Paper No. 1 of this series addressed bank structures for offering products and safeguards that exist in current law. It also addressed in abbreviated form the issue of a safety net subsidy. This paper draws on materials from that paper and goes further in addressing the issue of a perceived subsidy effect.

II. Subsidy Defined

A subsidy is a payment, tax break or other action by the government to assist a particular group of individuals or businesses to achieve a specific public purpose.[1] Examples are food stamps and low-interest rate loans that have the effect of raising or maintaining the standard of living for individuals. In the case of businesses, a subsidy is intended to cover or offset costs of producing certain goods and services. In the absence of a subsidy, the income and resulting spending of individuals would be lower than with a government subsidy, and, in the absence of a subsidy, the income of a business would be reduced.

A government subsidy represents the opposite of an excise or special tax on individuals and businesses and, for that reason, a subsidy often is referred to as a *negative tax*. Subsidies and special taxes result in competitive economic distortions.

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[1] *See* Donald Rutherford, *Routledge Dictionary of Economics* (London 1995 ed.), p. 444.

III. Safety Net Subsidies

Three subsidies from the federal safety net have been identified for banks.

The first is the insurance of bank deposits, which is argued to increase the supply of funds that individuals and businesses would make available to banks. At any given interest rate, the funds that individuals would make available to banks would be larger with deposit insurance than without insurance, all other factors being equal. It is thus argued that banks enjoy a subsidy by virtue of being able to obtain funds more cheaply than competitors that are unable to offer insurance on the invested or deposited balances. Competitors claim they must offer higher interest rates than banks in order to obtain invested or deposited balances as a means of overcoming the subsidy effects of deposit insurance protection.

A second subsidy for banks arguably results from access to the payments system, which is limited to insured depository institutions. The subsidy for banks in this case is said to arise from the Federal Reserve's nationwide check clearing operations and the clearing and settlement of final payments through FedWire, the Federal Reserve's electronic clearing and settlement system. Federal Reserve payment services for clearing and settlement, however, have been priced to cover fixed and variable costs plus a "normal profit," meaning that no subsidy exists merely by reason of access. The finality feature when payments are made using FedWire is said to provide banks with a particular advantage over nonbank competitors that do not have access to FedWire or Federal Reserve check clearing services.[2]

The subsidy effect allegedly arises because finality allows banks to supply payments services they would not otherwise be able to offer at any given price in the absence of that service and that the public prefers to deal with a company with such access. The contention is that nonbank competitors experience higher costs than banks in providing payments services to customers as a result of the subsidy. Finality benefits have been offset in recent years by the Federal Reserve's imposition of net debit caps on non-book entry FedWire overdrafts (a form of credit limit) and by fees

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[2] FedWire is a system by which the Federal Reserve immediately debits and credits, in real time, the accounts of sending and receiving institutions. All payments are irrevocably and unconditionally final, meaning that the receiving bank receives good funds at the time of transfer even if the sending bank fails to settle its position with the Federal Reserve. For a discussion of FedWire see Volume II of *Banking's Role in Tomorrow's Payments System*, prepared by Furash & Company for The Bankers Roundtable (June 1994), pp. 45-54. Also see, *The Federal Reserve and the Payments System*, Occasional Paper No. 2 (The Bankers Roundtable April 1997).

the Federal Reserve charges for daylight overdrafts. Any subsidy from finality, therefore, would be very small.

A third subsidy afforded banks is argued to exist by virtue of bank access to the Federal Reserve's discount window. The discount window provides banks with access to borrowed funds on a collateralized basis from the Federal Reserve. Only insured depositories are allowed access to borrowings at the Federal Reserve, which is argued to place them at a competitive advantage, such as being able to hold lower levels of liquid assets. This is viewed as particularly important in times of economic stress, thereby further enhancing the value of bank services.

Discount window access is not routine for banks. Markets also are aware that discount window operations benefit the market as a whole, being employed mainly to avoid systemic problems created by stock market disruptions and liquidity crises. Indeed, banks faced with insolvency are prevented from accessing the discount window and many banks, during the difficult economic times of 1987-1992, found themselves being closed by the FDIC, not assisted by the Federal Reserve.

Collectively, these three subsidies have been termed the "safety net subsidy." This "safety net subsidy," however, is minimal and disappears altogether when the historic costs associated with the deposit insurance system and other safeguards imposed on banks are taken into account. The result, then, is a net minus subsidy. Further, subsidiaries and affiliates share no such subsidy due to costs, additional safeguards or other restrictions. Finally, the safety net intends to protect depositors and the financial system above and beyond any benefit that flows to banking institutions. While competitors raise concerns about a subsidy effect, they effectively compete with banks in offering bank-like products to customers without the safety net.

Clearly the value of a subsidy may be viewed differently in good versus bad economic times. What follows is an attempt to look to the measurable, tangible elements of a subsidy; intangible, purported subsidies are addressed with historic evidence that runs contrary to any supposed benefits.

IV. Gross Subsidy Appears Small

In General

Those who have attempted to show a safety net subsidy either have been unable to demonstrate it empirically without criticism of their methodology or the variables they have employed, or they have been able to determine only a minimal subsidy effect.

Empirical studies to determine whether banks benefit from any net subsidy or other advantages have been, at best, inconclusive.[3] Demonstrating any competitive advantage, and measuring or assigning a value to any such advantage, has proven very difficult. The large number of variables impedes solid conclusions on the size and scope of a subsidy; variables include geographic locations, market size, size and type of competitors, demographics, institution management, affiliations, product offerings and mix of products, regulatory scheme, taxation (nationally and locally), marketing, and profitability in any given time frame. Estimates of postulated "subsidies" from deposit insurance rely on pricing models that make assumptions about bank equity returns, closure period for a regulator, loss figures and the like. Different studies made over various time frames, with diverse economic conditions, have employed different assumptions and resulted in differing conclusions. In short, empirical studies have resulted in a wide range of varying results, creating doubt and rasing questions about the existence or size of the subsidy.

There is no compelling evidence that a subsidy exists at any significant gross level, when all other factors are held constant. Finding a gross subsidy requires that any funding advantage it provides be weighed against the funding advantages competitors possess and the effect that bank operating costs have in offsetting any gross subsidy.

Nevertheless, it is probably safest to argue that some small, gross subsidy does exist. With studies suggesting a gross subsidy value from the safety net ranging from 6 to 16 basis points in funding costs, a gross subsidy of 14 basis points will be used here.

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[3] *See* Flood, "On the Use of Pricing Models to Analyze Deposit Insurance," *Economic Review* 34 (Federal Reserve Bank of St. Louis January/February 1990).

Deposit Insurance Gross Subsidy

The perceived benefit for banks as a result of deposit insurance has been estimated from four basis points up to fourteen basis points. This is the advantage seen arising for banks from access to funds from depositors through insured accounts versus the costs for competitors in securing uninsured sources of funds.[4] Based on the variety of studies, including a review requested by The Bankers Roundtable, the gross subsidy value of deposit insurance would be estimated at about twelve basis points.

Of note, safe banks-- the vast majority of banks-- create no burden on the deposit insurance system and, arguably, are overcharged for deposit insurance, rather than enjoying any gross subsidy. Their insurance premiums exceed actual payouts stemming from failures.

Unsafe banks, it may be noted, particularly during the time frame of 1987-1991, were closed, with a direct impact on their shareholders and creditors. During that time frame, the entire financial system benefitted from the existence of a federal safety net that conveyed stability to the marketplace.

A subsidy should show a benefit and affect behavior. A deposit insurance subsidy, for example, would suggest increased reliance by banks on insured deposits. Ironically, banks have moved in the opposite direction, gradually reducing reliance on insured deposits.[5] If there were a subsidy, banks would be expected to rely on "subsidized funds" rather than moving away from use of such funds. The evidence of

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[4] FDIC Chairman Helfer in congressional testimony noted most estimates of a deposit insurance subsidy have been under 10 basis points; *see* footnote 11, *infra*. A formula for computing an insurance subsidy was prepared separately for the Roundtable by David Humphrey. He used the formula {[(rCD - rTB x IDEP] - [rFDIC x DEP]}/TL, where rCD = bank rate on 90 day uninsured CDS (bank risk), rTB = rate on 90 day Treasury bills (government liabilities), rFDIC = rate paid for FDIC insurance, IDEP = value of insured bank deposits (approximately, DEP - large CDS), DEP = value of total bank deposits, and TL = value of total bank liabilities. Using a five year average for the spread between uninsured CDS and Treasury bills of 32 basis points and an average cost of deposit insurance of 10 basis points and employing recent values for deposits and liabilities, he produced a gross subsidy value from deposit insurance of 12 basis points. This aligns reasonably with the FDIC report of subsidy measures.

[5] Note that during the debate over the Savings Association Insurance Fund, thrift institutions argued that if the fund did not receive assistance and their premiums remained higher than those paid by commercial banks, then the thrifts would seek other funding sources, including Federal Home Loan Bank advances, that are based on capital market funding.

funding patterns for banks does not confirm the existence of any significant funding subsidy from deposit insurance. Deposits as a percentage of total bank assets declined from more than 90 percent in 1950 to less than 70 percent in 1996. While a number of factors may contribute to this trend, a major funding advantage from deposit insurance should have translated into increased or at least stable, but not diminished, reliance on deposits. Additionally, the 1991 banking law limits any coverage for uninsured deposits or other funding sources for banks, effectively constraining any "too big to fail" doctrine on the part of regulators. Large banks have drawn on capital markets and other funding sources for many of their operations, and many bank subsidiaries also seek funding in the capital markets.

Discount Window and Payments System Access Gross Subsidy

Discount window and payments access have translated into little competitive edge for banks in the marketplace. Though access to these services may be special, its impact on banks, in the form of subsidy or benefit, is minimal.

Discount window access produces a gross subsidy, it is argued, as banks benefit by the ability to borrow from the Federal Reserve, while competitors cannot, especially in emergency situations. As will be seen, estimates of this subsidy are in the range of one to two basis points. The measurable amount of the subsidy-- the relationship between the federal funds borrowing rate, a market rate, and the discount window loan rate-- has been estimated to be very small.[6] The benefit of this line of credit may be debated, especially since the Federal Reserve requires full collateralization and, as will be discussed later, the market valuation of this subsidy appears to be minimal. This is consistent with an estimate by the FDIC of a one to two basis point gross subsidy for discount window borrowing. This will be used as the upper range of the gross discount window subsidy for purposes of discussion in this paper.

Estimates of the subsidy from access to the Federal Reserve payments system-- FedWire-- are also rather small, in the range of one to two basis points. The measurable element of this appears to be less than one basis point. Comparing the costs of finality at private clearing services, such as the New York Clearing House

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[6] Employing a formula prepared by David Humphrey for The Bankers Roundtable: {(rFF - rDW) x DWL}/TL, where rFF = federal funds borrowing rate, rDW = discount widow loan rate and DWL = average value of discount window loans outstanding in a year, 1996 data produce a gross subsidy effect from the discount window of only .00109 basis point.

Interbank Payments System (CHIPS) with FedWire, the gross subsidy associated with daylight overdrafts is minimal.[7] Taking the high side of any estimates, the gross subsidy will be seen in a range no higher than one to two basis points at the most.

Anecdotal Evidence of Gross Subsidy

An argument advanced as proof of a subsidy effect is that bank debt trades higher than holding company debt. Actually, this goes less to banks enjoying a subsidy, than to the regulatory structure that forces bank holding companies to support banks (but not the bank to support the holding company). Bank holding company creditors, like any bank creditor or shareholder, are at an extreme disadvantage vis a vis shareholders or creditors of other corporations. First, in terms of priority in relation to government regulators in a bank liquidation, depositor preference rules tilt the balance in favor of the government. Second, regulators hold authority to limit bank dividend payments and to require bank holding companies to act on capital plans and to serve as a source of strength for subsidiary banks.[8]

For these reasons, holding company debt trades lower. Overall, arguments about price variances in debt may not be as valuable as looking to funding costs. The FDIC concluded, after reviewing its own data and Federal Reserve studies, that the funding cost difference between banks and bank holding companies varies by less than four basis points even before accounting for offsetting costs.

Summary

Collectively, the gross safety net subsidy for banks may be argued to exist in the 10-16 basis point range. Most of this is accounted for by the gross subsidy associated with deposit insurance, with the gross subsidy associated with access to the discount window and access to FedWire quite small. Using a higher end estimate

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[7] Using a formula prepared by David Humphrey for The Bankers Roundtable: {[CHIPS finality cost @ 25 bp - FedWire finality cost @ 15 bp) x DO x 255/365}/TL, where DO = value of average day's daylight overdraft on FedWire (approximately $45 billion) and 255/365 = business days of the year adjustment factor (FedWire subsidizes only during business days), a .08 basis point subsidy would exist.

[8] Indeed, nonbanking firms seeking to own banks clearly do not view these regulations as some advantage and have advocated eliminating or reducing the role of the Federal Reserve Board as an umbrella regulator for affiliated companies.

for the deposit insurance subsidy of 12 basis points and a higher end estimate of one basis point (or less) for both the discount window borrowings and payments system access, a gross subsidy from the federal safety net could be as high as 14 basis points.

V. Gross Subsidy Within a Bank Offset by Costs

Whatever the actual level for the gross subsidy resulting from the federal safety net turns out to be, it is more than offset by bank costs, evidence of which may be documented and demonstrated. Regulatory compliance expenses more than offset any subsidy benefits and generally by a wide margin.[9] These costs are substantial.

First, the newly imposed requirement for banks to contribute to the payment of interest on Financing Corporation obligations will cost banks 2.4 basis points for nearly nineteen years. Sterile reserves held by the Federal Reserve Board have been estimated to cost banks about two and two tenths basis points a year. These two items alone would offset nearly a third of the suggested 14 basis point gross subsidy.

In addition, the overall burden of bank regulatory compliance opportunity costs have been estimated as high as 45 basis points and no less than 20 basis points. The FDIC estimates a regulatory cost of 34 basis points. In congressional testimony, FDIC Chairman Helfer noted that, with conservative estimating, the sterile reserve requirement cost to banks represents 2.2 basis points, the FICO assessment cost constitutes 2.4 basis points and, based on a Federal Financial Institutions Examination Council study and others, an additional regulatory cost of 30 basis points. The FDIC Chairman said that "...the total offset, including reserve requirements, FICO interest payments, and regulatory burden, is estimated to be more than 33 basis points for banks and more than 38 basis points for thrifts. After the FICO payment is equalized, this offset will be approximately 34 basis points for banks and thrifts."[10]

Adding all of this together, a thumbnail estimate puts the gross subsidy at 14 basis points and the offsetting costs on banks in range of 24.5 to 49.5 basis points,

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[9] *See* Testimony of Eugene A. Ludwig, Comptroller of the Currency, before the Subcommittee on Financial Institutions and Consumer Credit, Committee on Banking and Financial Services, U.S. House of Representatives (Feb. 13, 1997), p. 10 ("Despite large amounts of empirical work on the subject, there remains considerable doubt as to whether any [funding] subsidy [for banks] exists. . . . In any event, to the extent any funding subsidy does exist, it is probably more than offset by the costs of regulations that banks must bear. Thus, banks actually face higher costs than other financial service providers when the costs of examinations, reserve requirements, and safety and soundness compliance regulations are considered.").

[10] *See* Testimony of Ricki Helfer, Chairman Federal Deposit Insurance Corporation, before the Subcommittee on Capital Markets, Securities and Government Sponsored Enterprises, Committee on Banking and Financial Services, United States House of Representatives (March 5, 1997), p. 58.

with a resulting net subsidy of minus 10.5 to minus 35.5 basis points. Using the FDIC estimate of 34 basis point as offsetting costs, the net subsidy would be minus 20, which is in the middle of the range.

Anecdotal evidence reinforces these numerical estimates. If a net subsidy existed, banks would be expected to enjoy unusual profits, higher stock market values, growing market share, a large number of new entrants and bond ratings higher than the companies to which they lend. None of this is in evidence. This is explored further in the discussion of subsidy transfers to bank affiliates and subsidiaries that follows in the next section.

Even if net subsidies are argued to exist, regulators can and have acted to limit the "extension" of any net subsidy. Clearly, prompt corrective action and high capital standards limit the extension of any subsidy. Further, regulatory approaches have been employed to limit subsidy extension, control moral hazards and limit taxpayer risk. These approaches include capital requirements, supervision and examination to insure banks maintain effective internal controls and maintain a risk management process, restrictions on activities that do present undue risk, limitation on the location of riskier activities and limits on transactions between banks and these business that have been located outside the bank.[11]

The subsidies of the federal safety net in and of themselves have not provided banks a competitive edge. The subsidies at the gross level are more than offset by regulatory costs associated with being a bank offering insured deposits and having access to Federal Reserve services.

As shown in the following summary table, the net subsidy from the federal safety net is negative under even high estimates for the gross subsidy.

The Roundtable conclusion, using the range of estimates and taking a conservative approach, cites 14 basis points as the gross subsidy and offsetting costs of 34 basis points, putting a net subsidy at minus 20 basis points.

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[11] Laurence H. Meyer, Member of the Board of Governors of the Federal Reserve System, "Financial Modernization: Rationalizing the Structure of the Financial Services Industry," presented at the 99th Assembly for Bank Directors, Southwestern Graduate School of Banking (January 24, 1997).

Summary Table

Estimated Subsidy		Estimated Costs	
Deposit Insurance	8-12 bp	Regulatory Compliance	24-45 bp
Payments System	1-2 bp	Deposit Insurance	2.4-10 bp
Discount Window Access	1-2 bp	Sterile Reserves	1-2 bp
Gross Subsidy	10 to 16 bp	Gross Costs	27.4 to 57 bp

Range of Estimated Net Subsidy: -11.1 to -47 basis points
Roundtable Estimated Net Subsidy: -20 basis points

VI. No Subsidy to Affiliates or Subsidiaries

Any comparison of advantages from affiliation with an insured depository institution cannot be reviewed without considering the disadvantages and associated costs. If the safety net provides a subsidy to banks, that subsidy is offset by extensive costs. Adding the layering of a subsidiary or affiliate relationships and the extra regulatory rules that apply means that, even if a net subsidy did exist for a bank, an additional array of costs arise to offset such a net subsidy.

The costs imposed on subsidiaries and affiliates by federal and state banking regulation are substantial. Regulatory burdens that accompany affiliation with a bank include holding company capital ratio requirements, applied on a consolidated basis; holding company-wide examinations and oversight; prudential and safety and soundness restrictions and policies, including restrictions on investments, asset concentration limits, *etc.*; Bank Holding Company Act (BHCA) application and notice requirements before conducting new activities or making investments; the possibility of being called upon to support the bank under the Federal Reserve's "source of strength" doctrine; and affiliate and insider transaction restrictions.

Along with many commentators, the OCC and FDIC have noted the sizeable costs of regulation on banking institutions and their affiliates and suggested that these offset the advantages claimed for banks and their affiliates.[12] More than one writer has noted that, when banks and their affiliates expand business lines, supervision with its attendant costs tends to expand as well.[13]

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[12] *See* footnotes 10 and 11 *supra*; also *see* FDIC, *Mandate for Change: Restructuring the Banking Industry*, (1987), p. 78 ("While banks possess certain competitive advantages, they are also subject to a wide variety of restrictions, controls and oversight from which other types of businesses are largely exempt. These government controls include capital, reserve, and lending requirements; geographic and product restrictions; and a host of other regulations and constraints. All of these impose costs on banks. There is no definitive answer as to whether the competitive advantages of being a bank outweigh the disadvantages.").

[13] F. Felsenfeld, "The Bank Holding Company Act: Has It Lived Its Life?" 38 Villanova L.R. 1 (1993) citing Shull, "The Separation of Banking and Commerce: Origin, Development and Implications for Antitrust," 28 Antitrust Bull. 255, 276 (1983)("Supervision becomes more pervasive without the need to enact laws or regulations because an expanding scope of activities becomes subject to the 'imposition of reserve requirements, deposit insurance, access to Federal Reserve services that accompanies these restrictions, and all the related regulations that are now viewed as necessary to protect the deposit fund'."). Felsenfeld continues that, even if the Bank Holding Company Act ("BHCA") were repealed, an enormous amount of residual regulatory authority exists in banking law and governing nonbanking enterprises, ensuring no gap of protection and costs attendant to such

Perhaps no one can truly say why one firm does better than another even within one industry, nor can one assign some absolute value to one element of a company's operation over time. If two firms were identical, serving identical markets with identical products and identical regulation and so on, then perhaps looking at one existing variation between the companies would be useful in assessing any competitive funding advantage. If all other variables were constant or equal (a difficult proposition to determine), then an advantage might be evidenced. Such constancy has not been the case.

Comparisons are even more difficult when the complex, diverse and rapidly changing nature of the financial services market is considered. Banks, their affiliates and their competitors can and do provide a wide variety of competing financial products in a large number of different forms, through different business organizations and under different regulatory structures. The marketplace and regulation continue to evolve, and past data and comparative studies quickly become dated.

Furthermore, before making assumptions about any perceived advantages or subsidy from federal bank deposit insurance, the advantages and value of insurance schemes for other financial industries-- such as SIPC insurance and state insurance guaranty funds-- should be considered.[14]

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insulation of a bank from an affiliate. ("Eliminating the BHCA would leave the great bulk of bank regulation intact. The regulations that treat banks as special institutions and those that regulate banks along with the remainder of U.S. business would be left undisturbed." p. 87; "It would be almost comical to suggest that the repeal of the BHCA would leave banks, including their relationships with their nonbank affiliates, as unregulated businesses. A vast body of statutes, regulations, orders, cases and tradition would remain in place." p. 90). *See also* preamble to the OCC's revised operating subsidiaries regulations, 61 FR 60342, 60354 (Nov. 27, 1996), where the OCC noted that "[F]ederal legislation in recent years has provided the federal banking agencies with additional supervisory tools to address promptly supervisory concerns that may arise in connection with activities engaged in by banks or their subsidiaries...These and other available supervisory actions provide the OCC with a substantial array of tools...to address risks presented by national bank operating subsidiaries." The OCC cited enhanced civil money penalties, prompt corrective action and divestiture authority as examples.

[14] It may be noted that nonbanks have access to banking products. Insurers have expressed little enthusiasm for affiliation with banks, arguing in part that they already have many of the benefits of bank-like products but without the heavy regulatory costs. Indeed, for insurers who do seek affiliation, the leading benefit has been cited as access to a delivery system, not access to insured deposits or the payments system. Finally, insurers have offered GICs, guaranteed investment contracts, that permit them to offer a product tied to an insured bank certificate of deposit without having to take a bank charter.

Bank affiliates, such as operating subsidiaries under OCC Part 5 rules or holding company subsidiaries, may experience roughly equivalent costs attendant to a relationship with a bank. Such diverse factors as tax treatment, corporate veil rules, regulatory limitations on uses of capital and dividends may apply to both corporate structures.

So, even if a net subsidy existed for a bank to be passed along to an affiliate, it would be offset by legal and regulatory rules. Even the concept of an "intangible subsidy value of access to the safety net" would not be transferred to an affiliate and markets recognize the limitations on any subsidiary operation's call on a bank. As noted earlier, the call is more likely to be made on an affiliated firm to assist a bank. If such a subsidy were found and were being transferred, regulators may limit such effect.[15]

Banks and companies affiliated with them pay, in effect, an opportunity cost as a result of deposit insurance. Banks and their subsidiaries and affiliates frequently are constrained or delayed in expanding into new product lines and activities by the need to address concerns of regulators, legislators and others over avoiding any perceived impact on the FDIC deposit insurance funds. Banks find themselves hard pressed to be affiliated with firms that seek to take risks in order to best the competition. "Insuring" the insurance fund has placed banks, if anything, at a competitive disadvantage and outweighs any arguable subsidy.

Marketplace Experience

Perhaps the best indication of the absence of a competitive advantage to bank affiliates is evidenced in the reality of the marketplace. As noted above, banking organizations can choose to operate many bank-related activities (such as mortgage

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[15] The issue of a transfer of safety net subsidy may be addressed not as a hypothetical, but rather with actual experience. Firms affiliated with unitary savings and loan holding companies appear to have enjoyed no market advantage from such affiliation beyond the desire to offer another product line. Ford Motor Company was not viewed as an "insured" automobile company while it owned a thrift, no one believes that USAA has a funding advantage over other insurers and no one believes that in an economic crisis Dean Witter would have better access to the discount window than any other securities firm. Congress has acted to limit perceived subsidy problems. For example, in 1987 banking legislation, Congress limited commercial firm access to the Federal Reserve payments system through their affiliated "nonbank banks." The law limited creation of overdrafts by a nonbank bank in its Federal Reserve account by or on behalf of an affiliate, that is, its parent company; 18 USC 1843(f)(3)(B)(iii). Simply put, existing evidence, not hypothesis, demonstrates no affiliate benefit from measurable or intangible subsidies and demonstrates the ability to limit access to any subsidy.

banking and securities brokerage) in any of several structures-- within a bank, a department, a subsidiary or a holding company affiliate. Each of these structures is used; often more than one structure is used even within the same banking group. This in itself runs counter to the idea of any deposit insurance or safety net subsidy. If a bank or its subsidiary represented a consistent advantage over other holding company subsidiaries then banks would have been expected to use it to the exclusion of other structures; this has not been the case.[16] Banking groups also continue to expand their use of uninsured funds, raised in the capital markets, to fund certain activities. Again, this is contrary to what might be predicted if there were a subsidy effect.

Additionally, access to the Federal Reserve discount window provides no significant competitive advantage to banks. Borrowings must be fully collateralized and must be used for liquidity not solvency purposes. Further, the concept of the safety net benefit of such access has been seen as much for nonbanks as banks. For example, the Federal Reserve used the discount window to ameliorate the impact of the silver market crisis involving the Hunt family and later, in 1987, employed the discount window to direct banks to assist securities firm with liquidity during the stock market drop of 1987; the law was amended, subsequently, to facilitate securities firm access to discount window advances.[17] The Federal Reserve has used the discount window to address systemic risk without limitation to banks. The discount window access, as with deposit insurance, has served as justification for operating rules applicable to banks which increase their costs. In the 1991 banking bill, access to the discount window was restricted for poorly managed banks.[18]

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[16] Indeed, FDIC Chairman Ricki Helfer demonstrated in testimony that of the 50 largest bank holding companies, a greater proportion of mortgage banking, commercial finance and consumer finance affiliate were in the holding company subsidiaries not bank subsidiaries, Helfer, p. 60 & Attachment 5 (March 5, 1997).

[17] FDICIA amended Section 13 of the Federal Reserve Act, 12 USC 343, to facilitate securities firm access to the discount window in times of a liquidity crisis by removing certain limits on using stocks, bonds and other securities for discount advances. The Federal Reserve retains the right to determine that no other source of liquidity were available and retains its general control over advances as noted at the end of 12 USC 343 that "All such discounts for individuals, partnerships, or corporations shall be subject to such limitations, restrictions, and regulations as the Board of Governors of the Federal Reserve System may prescribe."

[18] FDICIA amended Section 10(a) and (b) of the Federal Reserve Act, 12 USC 347b, to limit generally advances to an undercapitalized depository institution to no more than sixty days unless the Federal Reserve certifies the institution's viability. Critically undercapitalized institutions may not receive advances for more than five days and any losses incurred by the FDIC because the institution remained in business because of the advance must be reimbursed by the Federal Reserve. The Board

Payments system access remains limited. The Federal Reserve maintains controls over the system, inherently limiting any subsidy, with rules that control interaffiliate transactions and credit limits established by FedWire. Payments system access provides a benefit, but one which banks enjoy only to the limits of the additional costs imposed by regulation (which clearly offset the benefit). In any event, even if benefits rose above such costs, the benefits would not be passed along to bank affiliates or subsidiaries that access the payments system, just as a nonbank does, through an insured bank.

Comparisons with nonbank competitors show that banks and their affiliates have no clear advantage. Banks, their subsidiaries and affiliates are and have long been active in a wide range of nonbanking financial products. Yet bank offerings of such products as IRAs, mutual fund sales and annuities are far from dominant in these markets and have not displaced or driven out nonbank competitors. In states where banks or affiliates offer insurance agency or underwriting, independent agents and underwriters offering the same product lines remain strong. Where banks operate mortgage companies, nonbank-affiliated mortgage companies thrive. Where banks offer securities brokerage affiliates, independent securities firms thrive. Where banks and affiliates offer "bank service corporation" services, such as check printing, financial courier services and other bank-related products, nonbank competitors and providers prosper.

It is worth noting that many firms urging a subsidy benefit for banks already compete with banks in providing mortgages, IRA accounts, uninsured deposit accounts and the like, apparently with no ill effect from any subsidy. Only when banks seek to offer products that these competitors may provide customers, but banks may not, do subsidy arguments arise.

The financial and capital markets do not recognize any uniform advantage to being affiliated with a bank. Rating agency reviews, financial analysts and stock market prices do not give a premium to companies simply because they are affiliated with banks. Indeed, the market may even discount a bank-affiliated firm because of concerns over the potential reach of banking regulators in the event the bank encountered financial problems. Contrary to any supposed advantage, there exists a market perception that the *affiliate* may be at risk in the event of the *bank's* failure. When in financial trouble, banks may seek support from their holding companies (under the source of strength doctrine) and from other affiliated insured banks and thrifts (under the cross-guarantee for commonly controlled depository institutions).

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was given authority to examine any bank or its affiliate in connection with an advance.

The market is well aware that the reverse is not true; nonbank affiliates cannot count on support from their affiliated banks in tough times.

If Banks Had An Advantage to Pass to Affiliates

Assuming, for the sake of argument, that an advantage could be shown for affiliates of banks arising out of the safety net, just as in banks, costs exist which offset such advantages. It is difficult to see how any subsidy or cost of funds advantage for a *bank* could help a subsidiary or affiliate, in light of Sections 23A and 23B, aggregated investment limits and the many other existing laws discussed above. A benefit would have to be passed along through investment or loans, and these are restricted under current laws.[19] If, after all this regulation, any competitive advantage or concern could still be demonstrated in practice-- from actual market experience rather than conjecture-- then regulators already have broad power to develop new safeguards as appropriate.[20]

A Final Argument

A final argument about the federal safety net subsidy has been posed as a question-- if there exists no subsidy, then why don't banks drop their charters? In other words, banks continue to seek expanded powers, but won't drop the benefits of a bank charter to get them, thus a subsidy must exist that offsets any bank costs. Strong rationales explain why banks do not act along this line of reasoning.

The failure to drop a bank charter does not imply that an advantage exists. Giving up a charter involves major corporate reorganizations, requiring renegotiation of thousands of contracts and raising important tax issues. Also, alteration of employee roles and responsibilities would prove a major management task. Overall, embarking on such a course would consume considerable resources, particularly

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[19] *See Mandate for Change*, p. 80 ("If nonbanking activities are conducted outside of banks, in subsidiaries or affiliates, Section 23A- and 23B-type restrictions would be able to provide effective controls on a bank's ability to finance nonbanking activities with federally-insured funds."). As noted above, the OCC's revised operating subsidiary rules will extend Sections 23A and 23B to subs of national banks that engage as principal in activities of types that are not permissible for banks themselves.

[20] *See* footnote 15, discussion of limitation on payments system access in 1987 for nonbank banks owned by commercial firms.

management time in the midst of highly competitive markets.

Banks, as with other businesses, operate globally and the bank "form" is a manner of doing business around the world. The safety net concept does apply in all countries and the bank charter is an old corporate form based on reliability in handling funds. Changing the charter would impact bank involvement in overseas markets both legally and in a business sense.

In general, it is too great a leap to conclude that the failure of banks to drop their charters evidences some benefit of a subsidy. Indeed, the evidence clearly illustrates that banks have had to work at operating more efficiently to overcome the costs of regulatory requirements that more than offset any measurable gross subsidy flowing from the federal safety net.

VII. Conclusion

A small gross subsidy may exist for banks. Even without calculating offsetting costs, the safety net subsidy would prove of little value in market competition.

The small subsidy is more than offset by the costs attendant to providing services regulated by the federal and state governments. Overall, a net cost exists for banks, not a subsidy.

No subsidy exists for bank affiliated companies as banks have a net cost. Even if a net subsidy existed, it would be offset by the costs of being affiliated with a bank.

In sum, the federal safety net continues to provide certainty for insured depositors and stability for financial markets. It has little if any effect on banks as competitors, an outcome reflected in statistical analyses, marketplace realities and history.

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

February 23, 1999

The Honorable James A. Leach
Chairman
Committee on Banking and Financial Services
U. S. House of Representatives
Washington, D. C. 20515

Dear Jim:

During my February 12 testimony before the House Banking Committee, you sought further information about how subsidiaries of banks could conduct non-banking activities safely and soundly, and without any unfair competitive advantage.

As I described at the hearing, a parent-subsidiary relationship can be structured so that the subsidiary poses no greater risks to a bank, and receives no greater benefits, than an affiliate engaged in the same activities. Under the basic corporate law of limited liability, a shareholder of a company (whether that shareholder be an individual or another corporation) cannot lose more than its investment in the company. Thus, a bank could not lose more than the amount it had invested in a subsidiary. In addition, we and Representative LaFalce have proposed prohibiting a bank from investing in, or lending to, its subsidiary any more than it could to an affiliate.

The subsidiary option contains an important benefit for banks and the federal deposit insurance fund that the affiliate option does not. If a bank were in trouble, it could sell its interest in its subsidiary, solely at its own behest, to replenish its capital. Likewise, if the bank were to fail, the FDIC could sell the bank's interest in the subsidiary to reduce any loss that the FDIC might incur in protecting the bank's insured depositors.

A question arose at the hearing about whether a bank would have greater exposure to a subsidiary than an affiliate because a subsidiary's results are consolidated for accounting purposes with those of the bank. In the financial markets, however, the most relevant financial statements are those of the *bank holding company*, not the bank. Large banking organizations issue all of their equity and a substantial portion of their debt at the holding company level. Thus, as the bank holding company's reported results include both subsidiaries and affiliates of a bank any possible accounting-induced incentives for a bank to prop up a subsidiary apply with equal force to an affiliate.

A further question arose about what would happen if a subsidiary were to experience losses exceeding its net worth. The bank's consolidated financial statements would include these losses

for generally accepted accounting principles (GAAP). However, upon sale or liquidation of the subsidiary, the bank would recognize the true economic result – and its loss could not exceed its investment in the subsidiary. Thus, under GAAP, upon sale or liquidation, any reported losses in excess of its investment would be reversed for accounting purposes.

Furthermore, as an additional protection, H.R. 665 would require a bank to deduct form its regulatory capital its entire investment in a subsidiary. H.R. 665 also would require the subsidiary to be deconsolidated for regulatory purposes. Thus, even if the subsidiary were to fail and the bank were to lose its entire investment, the bank's regulatory capital would not be affected. And to the extent that the bank's investment in the subsidiary had value, the bank's regulatory capital would increase upon the sale or liquidation of the subsidiary.

Enclosed is a more detailed description of these issues. I also am enclosing an editorial by three past chairmen of the FDIC analyzing these issues from their perspective. Please contact Assistant Secretary Carnell or me if you have any questions about the enclosed or any other matter.

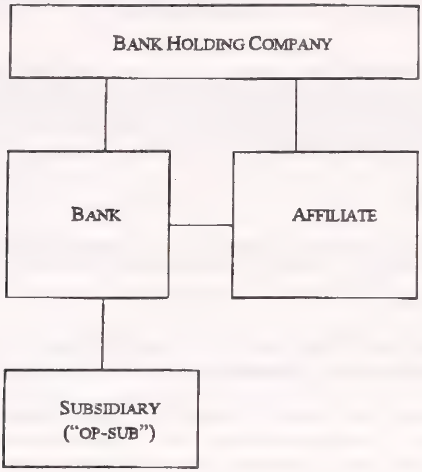
Sincerely,

Bob

Robert E. Rubin

1. ***What's the difference between a subsidiary and an affiliate of a bank?***

A "bank holding company" is a company that owns a bank. (For tax and other reasons, most U.S. banks are owned by holding companies.) An "affiliate" of a bank is a separately incorporated entity owned by the same bank holding company. A "subsidiary" of a bank is a separately incorporated entity owned by the bank itself.



2. ***What protections would exist to ensure that (1) the subsidiary does not pose a risk to the safety and soundness of its parent bank; and (2) the subsidiary does not derive an unfair competitive advantage by virtue of its affiliation with a bank (which receives deposit insurance and other federal subsidies)?***

Protections against risk and unfair competitive advantage are numerous and overlapping.

Limited Shareholder Liability

Under the most fundamental rule of American corporate law, a shareholder is not liable for the debts of a company in which it owns stock. *This is true regardless of whether the shareholder is an individual or another corporation. Each buys stock in a company: the potential gain in the value of that stock is unlimited, depending on the success of the company; however, the potential loss is limited by law to the amount of the investment. So, for example,*

someone who buys $100 of XYZ stock can see that stock grow many times in value, but can lose no more than $100.

Thus, even if a subsidiary were to go bankrupt, the parent would still stand to lose no more than its investment in the subsidiary. In other words, if a subsidiary has attracted additional capital from other investors or borrowed from other lenders, *those third-party investors and lenders -- not the parent bank -- would bear their own losses resulting from the subsidiary's default.*

Indeed, it is because of the potential for gain from a profitable subsidiary, and limitations against loss from an unprofitable subsidiary (both this one and those discussed below), that the FDIC -- through its current and past three chairmen -- has found that the subsidiary is actually *preferable* from the standpoint of safety and soundness.

Additional Protections

Limited liability means that a parent bank could lose no more than the amount it invests in, or lends to, its subsidiary. Additional protections could effectively limit *the amount* of such investment and lending. H.R. 665 (the LaFalce bill) would impose the following safeguards:

- A parent bank would have to remain well capitalized (i.e., in the highest regulatory capital category) and well managed, and would face sanctions if it failed to do so.
- Every dollar of a bank's equity investment in a subsidiary would be deducted from the bank's capital -- and the bank would have to remain well capitalized even after the deduction. Thus, even if a subsidiary were to fail and its parent bank's equity investment in it were totally lost, the bank would remain well capitalized. And to the extent the bank's investment in the subsidiary had value, the bank's regulatory capital would increase upon the sale or liquidation of the subsidiary.
- A bank could not make an equity investment in a subsidiary that would exceed the amount that the bank could pay as a dividend to its holding company (for investment in an affiliate).
- The bank could only lend to a subsidiary the amount it could lend to an affiliate -- 10 percent of its capital to any one subsidiary (or affiliate), 20 percent to all subsidiaries (or all affiliates). Also in keeping with current law, any such loans would have to be on arm's-length, market terms and fully secured by high-quality collateral.

Protection Against Unfair Competition/Subsidy Transfer

The funding limitations set forth above serve not only to limit the parent bank's exposure to the risks of its subsidiary but also to limit the ability of the bank to pass on any competitive

funding advantage it may derive from deposit insurance, access to the Fed's discount window, and access to the payments system (collectively, the so-called federal subsidy).

Currently, a bank can pass along any net subsidy (if there is one) to an *affiliate*, either by paying a dividend to its parent for investment in an affiliate or by lending to its affiliate. The LaFalce bill would prohibit a bank from investing in a subsidiary any more than it could pay as a dividend, and would prohibit the bank from lending to a subsidiary more than it could lend to an affiliate.

It is worth noting that any subsidy received by a subsidiary would be small, if measurable -- and no greater than that received by an affiliate. Currently, subsidiaries of banks engage in businesses such as mortgage banking, securities brokerage, and trust services. Eighteen foreign banks underwrite and deal in securities through subsidiaries in the United States, with Fed approval. There is no evidence that these companies are realizing any measurable competitive advantage by virtue of their status as bank subsidiaries.

3. ***Would generally accepted accounting principles lead banks to prop up troubled subsidiaries?***

At the hearing, it was noted that while corporate law would protect a bank from liability for subsidiary losses in excess of its own investment, such losses would appear on a bank's consolidated financials under generally accepted accounting principles (GAAP). The question arose whether this accounting rule was cause for concern.

The answer is no.

- *The most heavily relied upon, publicly reported GAAP-based financial statements are those of the bank holding company* This is because large banking organizations issue all of their equity and a substantial portion of their debt at the bank holding company level. *The holding company statements consolidate the financial statements of the bank with those of all affiliates as well as all subsidiaries.* Thus, if banks have a GAAP-induced incentive to prop up subsidiaries, they have the same incentive to prop up affiliates, because bank holding company financial statements that reflect an affiliate's poor performance would just as easily concern markets.

- *Accounting does not dictate liability.* As discussed above, it is a fundamental rule of American corporate law that a shareholder (whether an individual or corporation), is not liable for the obligations of a subsidiary — regardless of whether such subsidiaries are consolidated for purposes of generally accepted accounting principles.

- If a subsidiary were to develop trouble, H.R. 665 would prohibit a bank from making any investment that would leave the bank less than well capitalized, and would allow the bank to lend only on market terms and in limited amounts.

- A further question arose about what would happen if a subsidiary were to experience losses exceeding its capital.

    - The bank's consolidated financial statements would include these losses for generally accepted accounting principles (GAAP). However, upon sale or liquidation of the subsidiary, the bank would recognize the true economic result -- and its loss could not exceed its investment in the subsidiary. Thus, under GAAP, any reported losses in excess of its investment would be reversed for accounting purposes.

    - Furthermore, as an additional protection, H.R. 665 would require a bank to deduct from its regulatory capital its entire investment in a subsidiary. H.R. 665 also would require the subsidiary to be deconsolidated for regulatory purposes. Thus, even if the subsidiary were to fail and the bank were to lose its entire investment, the bank's regulatory capital would not be affected. And to the extent the bank's investment in the subsidiary had value, the bank's regulatory capital would increase upon the sale or liquidation of the subsidiary.

4. What does the case of First Options suggest?

First Options of Chicago, a subsidiary of Continental Illinois National Bank, suffered significant trading losses during the 1987 market crash. Continental Illinois incurred no losses over and above its investment in and loans to First Options -- even though there were then significantly fewer restrictions on a bank's dealings with its subsidiary than would be imposed by H.R. 665.

H.R. 665 would expressly limit the amount a bank could invest in, or lend to, its subsidiary. These limitations are much more restrictive than those that were in place in for Continental Illinois in 1987.

First Options was a registered broker-dealer and futures commission merchant. It executed and cleared trades on securities and commodities exchanges, and made margin loans to market participants.

First Options experienced liquidity problems on the day of the stock market crash of October 19, 1987. On October 20, in violation of OCC-imposed restrictions on its investments in and loans to First Options, Continental Illinois made a loan of $130 million to First Options. The OCC learned of the loan immediately, and immediately initiated enforcement action. The next day, the loan was repaid by the bank holding company.

First Options did not fail. It was sold by Continental Illinois in 1991.

The 1976 case of Hamilton National Bank and its mortgage lending *affiliate* provides an interesting parallel to First Options. The affiliate had originated more than $200 million in loans, funded by commercial paper issued by the bank holding company. Because of market concerns about real estate exposure, the holding company had difficulty rolling over its commercial paper. As a result, the mortgage affiliate increased its loan sales to the lead bank, Hamilton National Bank in order to raise funds. The poor quality of those loans ultimately caused the bank to fail. *At the time of failure, 87 percent of the bank's problem loans had come from its mortgage banking affiliate*. In the wake of the Hamilton failure, lending limits to affiliates were amended to include asset purchases. Under H.R. 665, those limits would protect affiliates and subsidiaries alike.

5. ***Doesn't a bank face the risk of "piercing the corporate veil" -- that is the possibility that a court will hold a bank liable for the debts of its subsidiary?***

Under the basic corporate law of limited liability, a shareholder of a company cannot lose more than its investment. There is a rarely used exception to this fundamental rule, which generally applies only where there is some combination of fraud, abandonment of corporate formalities, or where the owned company was inappropriately organized and maintained, such that creditors thought they were dealing with the shareholder. The remote possibility of "piercing the corporate veil," however, is no reason to deny banks the choice of operating through a subsidiary or an affiliate.

- Piercing of the corporate veil is extremely rare. Banks (and other companies) have operated through subsidiaries for many years, and we are unaware of problems arising in this area.

- The regulations and examinations undergone by banks are strong protections against the capital inadequacy and disregard of corporate formalities that can lead to piercing the corporate veil. In addition, H.R. 665 expressly directs the agencies to ensure that corporate formalities are observed.

- *The deposit insurance funds (and ultimately the taxpayer) could suffer no loss as the result of veil-piercing*. Judgment holders would be unsecured creditors and would therefore stand in line behind the FDIC in any resolution. We would support legislation making this clear.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

ALAN GREENSPAN
CHAIRMAN

March 3, 1999

The Honorable Marge Roukema
Chairwoman
Subcommittee on Financial Institutions and
Consumer Credit
Committee on Banking and Financial Services
House of Representatives
Washington, D.C. 20515

Dear Madam Chairwoman:

I am writing in response to your request for additional information about the Continental Illinois/First Options experience and to respond to other interpretations regarding what that and similar experiences demonstrate. I agree with your view that First Options is central to the question of operating subsidiaries. It can be highly instructive as the Congress considers financial reform.

When considering events surrounding First Options, it is useful to have sufficiently detailed facts. For that purpose, I refer you to the enclosed summary of relevant events, which draws heavily on documents prepared by staff of the Federal Reserve Bank of Chicago and by others who were closely involved in the matter. I believe that this summary and similar, related experiences highlight several realities:

- Firewalls between banks and operating subsidiaries sound good, in theory, but in practice they rarely hold during periods of actual market or institutional stress. Operating subsidiaries have traditionally been viewed as integral parts or departments of the parent bank and have been managed on that basis. In times of stress, human nature, the pressures of the market place, and the need for institutions to support their weak subsidiaries take quick priority. As a practical matter, banks, which rely on reputation and market confidence for funding, cannot readily afford to allow a direct subsidiary--an entity that they own and control--to fail without severe consequences. Formal restrictions and firewalls, some like those that the Treasury now proposes, were also imposed on Continental Illinois, but they were violated as soon as First Options required support. Despite the fact that First Options was a "separate entity," the parent

bank perceived that it had little choice if it was going to protect its reputation as a viable going concern.

- A parent's losses related to operating subsidiaries can be far greater than the parent's equity investment. Total exposures extend beyond formal investments to all forms of credit extensions, including intraday obligations. Continental's initial purchase price was only $125 million, but the bank's losses on First Options ultimately totaled nearly $300 million. In fact, First Options lost twice the amount of its own capital in the October 1987 stock market crash. While this had an adverse effect on the parent bank's financial condition, abandoning the operating subsidiary was not a realistic option.

- Firms generally encounter significant difficulties selling "problem" subsidiaries. Even when possible, such sales can take considerable time and require further exposure and expense as well as substantial concessions to the purchaser. Continental required nearly two years to sell First Options after publicly announcing the firm was for sale and still needed to provide the buyer with highly favorable terms. The U.S. government had a similar experience in selling troubled thrifts. The notion that problem subsidiaries can be easily sold or liquidated without adverse repercussions to the parent bank is beguiling, but experience and the realities of the market place strongly suggest that it cannot be relied upon. This is true particularly in times of stress, when the insured depository and the safety net are at risk. In contrast, a profitable subsidiary of a bank can be sold more readily, just as a profitable affiliate of a holding company can. The proceeds of either can be used to increase the capital of an affiliated bank.

- The threat of supervisory action is frequently not an effective deterrent to exceeding regulatory limits when solvency is at stake, and, once a violation has occurred, supervisory remedies may be limited by the bank's own vulnerable financial condition. The threat of supervisory action, including civil money penalties, generally pales in comparison to the threat of insolvency. Moreover, our experience has been that once such situations have occurred, requiring reversal of the offending transaction is frequently not a regulatory option, in that doing so may further threaten the viability of the insured institution. Significant monetary penalties can have the same effect. Prevention of exposure to the federal safety net is key.

These points and many other lessons learned from numerous situations help to remind us of the special circumstances surrounding banks. By their very nature, banks must deal constantly in financial markets and, more than most institutions, must maintain strong reputations. When that's lost, banks cease to be viable. Fortunately, with Continental/First Options, the holding company was in a position to provide direct support when the bank's unauthorized assistance became known.

Despite the holding company's support, significant time was required to sell First Options, even after many of the problems and uncertainties surrounding the 1987 market crash had waned. Experience has shown that selling any firm in the heat of the moment as losses mount would be virtually impossible. In theory, another alternative would be to place the subsidiary in bankruptcy to halt further accounting losses. How quickly that decision could be made and implemented however is far from clear.

Making the decision to file bankruptcy would require that other more favorable alternatives could be ruled out; yet, it is rarely if ever clear in the midst of a crisis that there is no prospect for recovery or no buyers and that bankruptcy should be pursued. Even determining the extent of loss in the problem company may take time. Moreover, we have witnessed many banks that were optimistic about their future prospects in the most dire circumstances. We can recall countless meetings to resolve situations that may have initially appeared hopeless, but where the bank brought in consultants and investment bankers that expressed confidence in proposed resolutions. Some of these prospects were ultimately successful but others were not. In addition, placing a subsidiary in bankruptcy is not without legal risk to the parent bank. In short, future prospects in the midst of a crisis are rarely clear either to the bank or the regulator and reasonable management would, it seems, want a very clear picture before taking such an extreme step as placing a subsidiary in bankruptcy. We are not aware that the bankruptcy option was exercised to any significant degree, if at all, by thrifts in resolving significant problems in their service corporation subsidiaries during the thrift crisis.

It has been suggested that, in any event, the accounting effects on a parent bank's balance sheet are immaterial because "the most relevant financial statements are those of the bank holding company, not the bank." In fact, financial markets make wide use of bank holding company and bank financial information made publicly available quarterly by banks and regulators. Significantly, as problems in a bank operating subsidiary develop, depositors and counterparties will, as they have in the past, focus on the bank's balance sheet, since it is the bank's assets on which they have a direct claim. Even today, rating agencies assign different ratings to subordinated debt of the same firm depending on whether the debt was issued at the bank or parent level, generally assigning a

slightly more favorable rating to bank debt due to the presence of the federal safety net. As diversified financial firms expand in the market place, it is likely that even greater differentiation will be made by investors among the various banking, securities and insurance entities in which they have a direct financial stake.

While regulators could attempt to use regulatory accounting principles to disentangle the capital of the bank from the operating subsidiary, the markets and funding would still rely on statements in accordance with generally accepted accounting principles (GAAP) that consolidate the bank and its operating subsidiary. The pitfalls of utilizing regulatory accounting treatments that differ materially from GAAP presentations are well illustrated by the thrift crisis. Based on that experience and at the insistence of Congress, bank regulatory agencies have embraced GAAP to give the public a fair and consistent financial picture of banking organizations. It would seem to be in the public interest therefore to be consistent with GAAP where possible and heighten, rather than blur, the distinction between banking and nonbanking organizations. Placing firms in affiliates of the parent rather than as subsidiaries of the bank accomplishes that goal.

It is true that some of the costs and benefits associated with an operating subsidiary approach also apply to structures in which firms are held as direct nonbank affiliates of the holding company. Protecting one's reputation, for example, is crucial to banks and holding companies, alike, and both will necessarily endeavor to do that. The key difference, however, seems to be this: activities conducted through nonbank affiliates of the holding company offer a level of separation not provided by an operating subsidiary--which is directly owned and controlled by, and consolidated with, the parent bank. That separation, in turn, offers advantages to the safety net since the losses of a holding company affiliate do not as directly contaminate the financial strength, reputation, and liquidity of the bank. Moreover, efforts to impose firewalls or limitations that are designed to make a subsidiary of the bank look more like a holding company affiliate are not effective. Just as parents are more likely to come to the aid of their own children before nephews and nieces, a bank may be more tempted to assist a directly owned subsidiary than an affiliate of the parent. That should be particularly so in the context of the diversified financial firms we envision in which the bank is only one of several business lines.

In closing, the lessons we have drawn from the First Options case in the context of current legislative proposals are as follows:

- Deductions of operating subsidiary investments from regulatory capital are an inadequate protection as banks may lose multiples of their original equity investment quickly. First Options shows that a bank can lose more than its investment in a subsidiary. Moreover, First Options is a clear example where the sale of the subsidiary did not replenish the capital of the bank, but in fact represented a loss of capital for the bank. If First Options had been a holding company affiliate (rather than a subsidiary of the bank), no losses would have accrued to Continental Bank.

- Actions to limit subsidiary losses may be ineffective as events evolve so rapidly that banks and regulators will have difficulty in selling the subsidiary quickly or placing it in bankruptcy to contain losses to the insured depository.

- Firewalls, which are not impervious during times of stress, are more likely to be breached for operating subsidiaries than holding company affiliates. Insured depositories have a greater incentive to rescue subsidiaries by breaching firewalls because of the direct effect they have on the bank's income, financial condition, reputation and funding. Therefore, holding company affiliate structures, though not failsafe, offer better incentives for insured depositories to maintain firewalls.

I hope this response is helpful to you as you consider this important legislation to modernize the U.S. financial system.

Sincerely,

Summary of the Experience of Continental Illinois
and First Options of Chicago, Inc.

Continental Illinois agreed to purchase First Options of Chicago (FOC) from Spear, Leeds, & Kellogg, a New York based stock specialist firm, on December 30, 1986 for $125 million, a price that included $79 million of goodwill. FOC executed customer trades and provided clearing services, margin financing, and related functions for customers consisting primarily of professional traders who executed transactions exclusively for their own accounts and had no customer relationships of their own. These customers were largely market makers, specialists, and floor traders acting in the capacity of individuals, partnerships, or corporations. FOC also conducted proprietary transactions of its own.

Continental decided to acquire the firm as an operating subsidiary of the bank, rather than as a nonbank subsidiary of the holding company, after preliminary discussions with the Federal Reserve raised questions about the full scope of First Option's activities and the risks and timing of the transaction. Previous Board approvals in related businesses had focused on retail clients, rather than on option and equity services for professional traders and other broker/dealers. Timing was an issue because both parties wanted to close the transaction before year-end for tax reasons. The transaction was also viewed as expansionary, which raised further questions given Continental's financial health and history.

The OCC approved the request on December 29, 1986 under authority of 12 U.S.C. 24 (seventh) of the National Banking Act. As part of its approval order, the OCC also imposed two conditions:

- The Bank's investment in, and loans to, FOC may not exceed in the aggregate an amount equal to the Bank's legal lending limit at the time of the investment or loan of any funds. The Bank shall not make any additional investments of equity capital in FOC without prior written consent of the OCC.

- The Bank shall seek and obtain written assurances from each securities and commodities exchange, and clearing corporation of which it is a member, that the exposure of FOC to that exchange or clearing corporation will be limited to the amount of capital of FOC, and that no claims will be made on the Bank or any of its affiliates for any liabilities.

As discussed below, the bank violated both conditions.

October 19, 1987 Market Crash

In addition to operational risks associated with execution and clearing, FOC was also exposed to significant credit risk as a result of its direct extensions of credit to customers to finance their positions and indirectly through its clearing responsibilities to exchanges and clearing organizations. As a clearing member, FOC guaranteed the performance of its customers and relied on margin deposits and customer assets to support its guarantee. Given FOC's significant role in clearing (15-30 percent of total clearing volume on many exchanges), it was crucial to the sound operation of the exchanges that the firm's obligations be met.

In the days leading up to and including October 19th's 508 point decline in the Dow, FOC experienced margin deficits in customer accounts totaling $121 million. These margin "fails" included substantial losses from several clients and smaller amounts from others.

In late October, following the market plunge, FOC announced that it would take a $90 million provision to cover the credit losses. That expense eliminated current earnings and resulted in negative equity of approximately $45 million—five times its earnings the year before. This loss was reflected in the parent bank's financial statements.

Funding in the wake of the stock market crash also became a concern, as FOC was forced to cover customer liabilities. To meet its obligations, FOC turned to its parent bank, which increased its total loans and investments to a peak amount of $635 million by October 20th. Despite the fact that FOC was a legally separate entity, the advances from the parent bank were necessary to prevent a default by FOC and extremely adverse market consequences for the bank. As $508 million of the $635 million was unsecured, the credit extension exceeded by $130 million the legal lending limit established in the OCC's approval order. To correct that violation after the fact, the holding company advanced FOC $130 million on an interest free basis the next day. These funds were later used to recapitalize the firm.

FOC also did not comply with the OCC's second condition of approval. While the legal lending limit violation was resolved, FOC had yet to obtain written assurances from the exchanges and clearing organizations that the exposure of FOC would be limited to its capital and that no claims would be made on the Bank or its affiliates. Indeed, several futures exchanges later adopted rules requiring written guarantees from parent organizations for "house" or proprietary accounts. Many of these requirements were referred to as the "First Options Rule."

FOC Finally Sold

FOC continued to languish after the October 1987 market crash, largely due to poor market volume, and a decision was eventually made to sell the firm. In the fourth quarter of 1989, Continental publicly announced that FOC was for sale, and took the somewhat uncommon step of deconsolidating the subsidiary in its publicly reported financial statements. At the same time, Continental took a $62 million after-tax charge to cover the expected cost of disposition of FOC. While Continental expressed confidence that FOC would be sold within a year, few prospective buyers were interested, and the subsidiary was not sold until May, 1991 - to the company from whom the bank had originally purchased FOC. Moreover, the terms of the sale were preferential to the buyer, leading to speculation that Continental Bank had, in substance, paid the buyer to take FOC. Also, by May, 1991, the bank had been required to take additional write-down's on its equity investment in FOC (deconsolidated), bringing Continental's total losses on the venture to $287 million (see below).

Losses From First Options	1987	1988	1989	1990	1991	Total 87-91
Loss from operations	(102)	(30)	(77)	(4)		(213)
Loss from disposition/write-downs	0	0	(62)	(9)	(3)	(74)
Total Losses	(102)	(30)	(139)	(13)	(3)	(287)

Source: Continental Bank Corporation Annual Reports

Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

March 24, 1999

The Honorable John J. LaFalce
Ranking Democratic Member
Committee on Banking and Financial Services
House of Representatives
Washington, D.C. 20515

Dear Congressman LaFalce:

I am writing in response to your request for my views on the March 3, 1999 letter from Federal Reserve Board Chairman Alan Greenspan to Chairwoman Marge Roukema, regarding the experience of Continental Illinois National Bank (Continental) and First Options, and how that experience is relevant to the issues concerning bank operating subsidiaries currently being considered by the Congress.

Chairman Greenspan states in his letter that the Continental/First Options experience can be highly instructive as the Congress considers financial services reform. On this point, he and I agree, but for quite different reasons. As I will describe below, I believe the Continental/First Options experience *supports* allowing banks to conduct additional financial activities in operating subsidiaries, subject to the prudential safeguards contained in the Leach-LaFalce proposal.

First, let me describe the Continental/First Options "experience" to which the Chairman's letter refers. My summary is based on descriptions of these events that were given in 1987, at the time the events occurred.

The Continental/First Options "Experience"

Continental acquired First Options in December 1986. First Options was primarily engaged in providing execution, clearing and financing services for professional securities, options and futures traders, and did not serve retail customers. These activities are bank permissible and could have been performed directly by Continental. When Continental acquired First Options, it chose to hold the firm as a subsidiary of the bank. When the Office of the Comptroller of the Currency (OCC) approved Continental's application to make the acquisition, the OCC imposed several special conditions on the bank that were not required by law. In particular, one condition specifically limited the aggregate amount of the bank's investment in and loans to First Options

to an amount equal to Continental's legal lending limit. The basic legal lending limit permits an unsecured loan to a single borrower in an amount up to 15 percent of a bank's capital; with a loan in an amount up to 25 percent of the bank's capital permitted if the additional 10 percent is secured by specified types of collateral.

When the stock market plunged on October 19, 1987, many of the broker-dealer customers of First Options were unable to make margin calls and First Options was required to cover its customers' liabilities. Continental contacted the OCC seeking permission to provide additional funding to First Options in amounts above the funding limits contained in the OCC's conditions of approval, so that First Options could meet its obligations and would not be deemed in default in complying with the requirements of the various exchanges. The OCC declined to permit Continental to advance such additional funds to First Options.

Nevertheless, on October 20, 1987, in contravention of the OCC condition Continental lent additional funds to First Options. The OCC immediately directed the bank to reverse the transaction, issued a cease and desist order against Continental, and the transaction was reversed by the bank within 24 hours. Subsequently, Continental's holding company provided funding to First Options.

It is important to note that, at the very time these events were occurring, senior officials of the Federal Reserve System, seeking to bolster securities market participants in order to maintain liquidity in the securities markets, were urging lenders to "keep the spigot turned on" to continue to provide funding to broker-dealers.[1] In explaining Continental's actions to Congress in 1988, Thomas Theobald, then Chairman of Continental, recounted that at the same time that the OCC was telling Continental that it must adhere to the limits of the approval conditions, Federal Reserve System officials called him personally to urge that Continental continue to provide liquidity to the "financial system."[2]

The Lessons from First Options

Chairman Greenspan's letter to Chairwoman Roukema suggests that three lessons can be drawn from the First Options case in the context of current legislative proposals. Let me summarize those lessons as described by Chairman Greenspan and then explain why they actually support exactly the opposite conclusion from what he suggested.

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[1] See, e.g. Jed Horowitz, *Small Brokers Sent Tumbling By After Shocks*, American Banker, October 22, 1987, at 2. "[A]ccording to various sources, the Federal Reserve Bank of Chicago, is encouraging banks 'to open the spigots' so that clearing firms can keep their customers in business." Id.

[2] See statement of Thomas Theobald, Chairman of Continental Illinois Corporation, in *Volatility in Global Securities Market*, Hearings Before the House Comm. on Energy and Commerce, 100th Cong. 2d Sess. 104 (Feb 3, 1988). Mr. Theobald testified: "[B]y October 20. . . the Federal Reserve System contacted major banks urging them to provide liquidity to the financial system. . . . *Continental Bank received such a contact that morning; I did, personally.*" Id. [emphasis added] While Mr. Theobald did not expressly state that Continental's decision to violate the OCC limits was based on the calls he had received from the Federal Reserve, the clear import of his testimony was that the bank viewed its decision to violate the OCC restrictions as consistent with the urgings it was receiving from the Federal Reserve.

- *Deductions of operating subsidiary investments from regulatory capital are an inadequate protection as banks may lose multiples of their original equity investment quickly. First Options shows that a bank can lose more than its investment in a subsidiary.*

First Options shows that a bank can lose a portion of its investment and lose money as a result of *continuing* to loan funds to a subsidiary. This actually points up the key difference between the First Options situation and a subsidiary that would operate under the Leach-LaFalce standards. Under the Leach-LaFalce safeguards, the amount of a bank's exposure in the form of equity investments in a subsidiary conducting new financial activities is capped. The bank would have to be well-capitalized after deducting 100 percent of its equity investment in the subsidiary from the bank's regulatory capital. Thus, even if a subsidiary incurred losses that exceeded the bank's entire investment in the subsidiary, the bank would still have to have sufficient capital to remain well-capitalized. Continental was not required to make any type of capital deduction for its investment in First Options.

In addition, under the Leach-LaFalce safeguards, loans to any subsidiary engaged in the newly authorized type of financial activities would be subject to the limitations and other standards of Sections 23A and 23B of the Federal Reserve Act. That means that the total amount of any type of credit extension to the subsidiary is capped at 10 percent of the bank's capital, and these extensions of credit must be *fully collateralized* and must be on market terms. Thus, a bank cannot lose any more from lending to a subsidiary than from lending to an affiliate. No such limits applied in the First Options situation. Accordingly, Continental was able to lend First Options up the 15 percent of its capital on a *totally unsecured* basis.

Moreover, it is simply inconsistent with market realities to suggest that if activities are conducted in an affiliate rather than a bank subsidiary, that the bank will be insulated from losses. As Federal Reserve Board Chairman Paul Volcker stated in Congressional testimony in 1986:

> Experience clearly indicates, however, that when a subsidiary or even a related business enterprise (such as a real estate investment trust) of a bank holding company experiences financial problems, strength will be drawn from other parts of the organization, (including banking subsidiaries) to protect the reputation of the entire organization. . . . [T]he financial problems of a parent or its nonbank affiliates will typically affect the financial position of affiliated banks even though certain provisions of law provide a degree of separation.
>
> When you have a troubled bank holding company, you will almost invariably find that management will have, by one device or another, tended to, if its got a strong bank, use the strength of that bank to support the rest of the holding company or vice versa. . . . You can do something as simple as declaring a larger dividend from the bank than you otherwise would declare simply because you've got to get some more capital into the rest of the holding company, and the bank is left in a less strong position than it otherwise would be if that possibility didn't exist.[3]

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[3] *Structure and Regulation of Financial Firms and Holding Companies*, Hearings Before the Subcomm. on Commerce, Consumer and Monetary Affairs of the House Comm. on Government Operations, 99th Cong. 2d Sess. 148, 209 (April 22, 1986).

Interestingly, even Chairman Greenspan supported this view. In Senate Banking Committee hearings held in December, 1987, shortly after the Continental/First Options events, Chairman Greenspan submitted to the Committee a Federal Reserve Board study that concludes:

> Theory, evidence, and regulatory policy appear to be consistent with the inseparability view of the BHC. . . . [F]unds do flow among BHC affiliates and that BHC management is generally inclined to support ailing nonbank affiliates by using available resources -- including those of bank affiliates. . . . BHC management, regulators, and market participants (i.e. the investing and depositing public) perceive the entire BHC organization as a financially interdependent entity. Consequently, it seems likely that the financial problems of a parent BHC and/or its nonbank affiliates would affect the financial position of affiliated banks.[4]

- *Actions to limit subsidiary losses may be ineffective as events evolve so rapidly that banks and regulators will have difficulty selling the subsidiary quickly or placing it in bankruptcy to contain losses to the insured depository.*

The assertion that it is completely up to the bank or bank regulators to determine whether a nonbanking subsidiary will be liquidated, placed into bankruptcy, or have its operations curtailed is simply unrealistic. Limitations on funding a subsidiary such as the Leach-LaFalce safeguards would in fact lead to the prompt resolution of an insolvent subsidiary (or a subsidiary that is undercapitalized under applicable regulatory requirements) unless that subsidiary finds an independent outside source of funds.[5]

Under our bankruptcy laws, an unpaid creditor of the subsidiary can force the company into bankruptcy. A subsidiary can also be forced to curtail or terminate activities or cease operations by the company's functional regulator, such as the SEC, or in the case of First Options, a self-regulatory organization like the Chicago Board of Options Exchange (CBOE). In the case of First Options, testimony in 1988 by regulators involved in the situation indicated that First Options faced failure, or at the very least, mandatory action by the CBOE to curtail activities and liquidate its positions in an attempt to bring it into compliance with capital requirements, had not the holding company, with Federal Reserve Board approval, provided additional funds. [6]

In sum, under the Leach-LaFalce safeguards, restrictions on the amount a bank may invest in and lend to a subsidiary would limit the amount of funding the bank may provide. Once these funding limits are reached, the subsidiary must find other credit sources to fund its operations. Unless the marketplace believes that the subsidiary is still viable, and assuming the Federal

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[4] *Legislative Proposals to Restructure Our Financial System*, Hearings Before the Senate Banking Comm., 100th Cong. 1st Sess. 871-872 (December 1, 1987).

[5] The bank cannot provide funds in excess of those limits without suffering significant enforcement sanctions. Moreover, since the time the First Options situation occurred, the ability of the Federal banking regulators to impose civil money penalties has been significantly increased, with maximum potential fines of up to $1 million per day in egregious cases.

[6] *Volatility in Global Securities Markets*, Hearing Before the House Comm. on Energy and Commerce, 100th Cong. 2d Sess. 82-91 (February 3, 1988).

Reserve Board does not permit a bank's holding company to prop up an undercapitalized or insolvent subsidiary, the subsidiary will be shut down, or its operations will be dramatically curtailed in order to staunch its losses, whether the bank wishes this result or not. Under the Leach-LaFalce provisions, it is not possible for a bank to keep an insolvent or undercapitalized subsidiary afloat after the bank's investment and loan limits are reached.

- *Firewalls, which are not impervious during times of stress, are more likely to be breached for operating subsidiaries than holding company affiliates.*

Nothing in the First Options experience justifies this assertion. Moreover, there is simply no empirical support for this conclusion. Indeed, even a few years ago, this was not Chairman Greenspan's view. In Congressional testimony he said:

> My concerns with issues with respect to, for example, subsidiaries of banks as distinct from parents, *have very little to do with the firewall question* which a lot of people have argued in favor of and more to do with the question of the subsidy that is involved that commercial banks would move to the subsidiary of the bank as distinct from the issue of believing you can move institutions away from the bank by erecting significant firewalls.[7]

On another occasion, Chairman Greenspan also testified that his concern with the subsidiary approach was not firewalls, but "piercing the corporate veil":

> We would be concerned if the securities affiliate was a subsidiary of the commercial bank, largely because it would be quite easy to penetrate the corporate veil. . . . That in my view, is the major reason why we want to make certain that it is outside the line of ownership so that if the securities affiliate is owned by the bank holding company, it has no direct relationship to the commercial bank.[8]

Indeed, in 1987, Chairman Greenspan seemed to think that the "firewall" limiting transactions between Continental and First Options had worked satisfactorily. He testified that:

> What basically happened was the type of thing which one would expect to occur to one or two or maybe more types of institutions when one is confronted with such an unprecedented change in the financial markets. *I think the issue was basically contained.* I don't think that there was a particular problem created with respect to the overall financial system.

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[7] *HR 1062, The Financial Services Competitiveness Act of 1995, Glass-Steagall Reform, and Related Issues*, Hearings Before the House Comm. on Banking and Financial Services, 104th Cong. 1st Sess. 32 (February 28, 1995).

[8] *Reform of the Nation's Banking and Financial Systems*, Hearings Before the Subcomm. on Financial Institutions of the House Comm. on Banking, Finance and Urban Affairs, 100th Cong. 1st Sess. 42 (Nov. 18, 1987). According to an extensive study conducted subsequent to Chairman Greenspan's remarks, the Chairman was incorrect in his belief that the courts would be more reluctant to pierce the corporate veil between companies organized in a holding company structure and companies organized in a subsidiary structure. *See* Robert Thompson, *Piercing the Corporate Veil: An Empirical Study*, 76 Cornell Law Review 1036 (1991).

> There was difficulty in which First Options borrowed from Continental Illinois Bank over its limit as required by the Comptroller of the Currency. Within 24 hours it was recognized that that was an improper action. It was reversed and the proper action in that case -- that is, additional assistance from the holding company of First Options -- was then initiated.[9]

There is a broader implication of this experience that should not be overlooked, bearing not on the integrity of firewalls, but on the respective roles of the agencies involved. Continental was put under unique pressure to continue funding First Options as a result of calls from senior officials of the Federal Reserve System on October 20, 1987, urging bank lenders to keep funding broker-dealers to maintain market liquidity. In the difficult days of October 1987, when the Federal Reserve was urging banks to continue to provide liquidity to securities firms, it was acting, quite properly, in its role as monetary authority and lender of last resort. Whether or not Continental should have viewed the Federal Reserve's urgings as justifying a violation of the restrictions OCC had placed upon Continental, as Mr. Theobald implied, there was, to say the least, a mixed message being conveyed to the bank. If it is now said that the Continental/First Options firewall briefly melted for one day in October 1987, it could be argued that very special pressures -- some of them emanating from the Federal Reserve System -- contributed to that result. Thus, if the First Options experience teaches any lessons, it illustrates that supervisory safeguards, including firewalls, *can* work, where they are effectively and vigorously overseen by regulators that are focused on preserving the safety and soundness of the insured institutions involved.

I hope this information is useful to you as the Committee continues its deliberations on financial modernization legislation. Please let me know if I can provide any further information.

Sincerely,

John D. Hawke, Jr.

John D. Hawke, Jr.
Comptroller of the Currency

cc: Chairman Leach
Chairwoman Roukema

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[9] *Legislative Proposals to Restructure our Financial System*, Hearings Before the Senate Banking Comm., 100th Cong. 1st Sess. 107 (December 1, 1987). [emphasis added]

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

ALAN GREENSPAN
CHAIRMAN

April 30, 1999

The Honorable Marge Roukema
Chairwoman
Subcommittee on Financial Institutions
and Consumer Credit
Committee on Banking and Financial Services
House of Representatives
Washington, D.C. 20515

Dear Madam Chairwoman:

Thank you for the opportunity to comment on points made by Comptroller Hawke in his March 24th letter to Congressman LaFalce regarding Continental Bank's experience with its subsidiary, First Options of Chicago, Inc. I believe it is important to the future structure and soundness of the U.S. banking system that the lessons from this experience be understood.

As an initial matter, it is important to note that the Comptroller's letter does not dispute the relevant facts presented in my earlier letter nor the significant lessons that are illustrated by the Continental Bank/First Options experience, namely that:

- Continental Bank lost more than twice its investment in First Options, making ineffective and illusory any attempt by regulators to limit losses by requiring parent banks to deduct amounts invested in a subsidiary from their own capital;

- the losses experienced by First Options occurred quickly, and the alternatives facing the regulators were both limited and unattractive;

- Continental Bank experienced significant difficulties in selling First Options, resulting in prolonged exposure and expense to the Bank; and

- in the heat of the crisis, regulatory restrictions did not prevent Continental Bank from violating OCC restrictions in supporting its subsidiary.

While not disputing these points, the Comptroller's letter uses quotes out of context to create the erroneous impression that the Federal Reserve—through its efforts to address risks to the stability of the financial system—was responsible for Continental Bank's violation of its lending limits to First Options. It further argues that the Federal Reserve has been inconsistent in characterizing operating subsidiaries and the merits of firewalls, while acknowledging that a bank is not fully immune to problems of its affiliates. Finally, the Comptroller asserts that the Continental Bank/First Options experience illustrates that the provisions of H.R. 10 would protect a parent bank from losses of an operating subsidiary. On each point, the Comptroller's letter is misleading or unsubstantiated by the evidence he cites.

First, the suggestion that the Federal Reserve is responsible for Continental Bank's lending limit violation is without merit. As the nation's central bank, the Federal Reserve becomes immediately involved in matters that threaten the stability of U.S. financial markets. That was clearly the case in October 1987. It is a matter of public record that our efforts involved discussions with leading banks to encourage them to provide liquidity to the markets. These discussions included calls to Continental. In no event, however, did we expect that Continental, Continental Bank, or any other institution would violate laws or regulations.

Indeed, in testimony following the event, both Continental's Mr. Theobald and former-Comptroller Clarke stated that Continental Bank believed it could provide funding to First Options because of its own interpretation of the lending restrictions imposed by the OCC.[1] Mr. Theobald's reference to calls made by the Federal Reserve to various banking organizations, including his own, was made clearly to help indicate the extent of market turmoil at the time, not to suggest that the Federal Reserve urged his bank to violate the law.[2]

As you know, the bank's violation was corrected shortly after the event, with replacement funding by the parent holding company. Providing support to its subsidiaries is generally an appropriate role for a holding company because such support does not put insured funds at risk. We would have preferred, of course, that the bank not have been subject to losses by its subsidiary in the first place. Fortunately in this case, the holding company was able to help because it had resources other than the bank. If holding

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[1] *Volatility in Global Securities Markets: Hearing Before the Subcomm. on Oversight and Investigations of the House Comm. on Energy and Commerce, 100th Cong. 105 (1988)* [hereinafter *Volatility Hearings*]; *Reform of the Nation's Banking and Financial Systems: Hearings Before the Subcomm. on Financial Institutions Supervision, Regulation and Insurance of the House Comm. on Banking, Finance and Urban Affairs*, 100th Cong. 15 (1987) [hereinafter *Reform Hearings*].

[2] See *Volatility Hearings* at 104.

companies become no more than shell companies under an operating subsidiary structure, the alternative of holding company support may not exist.

On the second point of consistency, as the Comptroller states, both Chairman Volcker and I have acknowledged the links that exist between banks and their holding company affiliates, and that even an affiliate framework will not completely insulate a bank.[3] That is obvious, consistent with the facts, and a statement I still support. It does *not*, however, suggest that affiliate and operating subsidiary structures present the *same degree* of risk to the bank. Both Chairman Volcker and I have stated they do not. I have made such comments throughout the past decade, as has Mr. Volcker.[4]

The Comptroller's characterization of Federal Reserve statements on this issue and related issues—such as the efficacy of firewalls—distorts our remarks and is clearly not supported by a more complete reading of the relevant testimony. The point Mr. Volcker and I both have made on several occasions, including in 1987 with respect to First Options, is that an affiliate structure provides *more* protection to a bank than an operating subsidiary structure. That fact, I believe, should be clear and not in dispute.

Furthermore, interpreting my 1987 comment that "I think the issue was basically contained" as meaning I believe the firewalls work well is particularly unfounded. Clearly, they did not work. The actions of Continental Bank exceeded permissible bounds. *That*, as I said at the time, is what one would expect in a period of turmoil.[5]

Whatever the difficulties in protecting a bank from problems of its holding company affiliates, it will be materially more difficult to protect a parent bank from problems of its own subsidiary(s)—regardless of any proposed safeguards. That is the third point I want to address.

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[3] See, e.g., *Legislative Proposals to Restructure Our Financial System: Hearings Before the Senate Comm. on Banking, Housing and Urban Affairs*, 100th Cong. 871-72 (1987) [hereinafter *Legislative Proposals Hearings*]; and *Structure and Regulation of Financial Firms and Holding Companies: Hearings Before the Subcomm. on Commerce, Consumer and Monetary Affairs of the House Comm. on Government Operations*, 99th Cong. 209 (1986).

[4] See, e.g., *Reform Hearings* at 5-7; H.R. 1062, *The Financial Services Competitiveness Act of 1995, Glass Steagall Reform, and Related Issues: Hearings Before the House Comm. on Banking and Financial Services*, 104th Cong. 13-14 (1995); and *Strengthening the Supervision and Regulation of Depository Institutions: Hearings Before the Senate Comm. on Banking, Housing and Urban Affairs*, 102nd Cong. 548 (1991).

[5] *Legislative Proposals Hearings* at 107.

The Comptroller states that, under H.R. 10, an insolvent operating subsidiary would be "shut down" or its operations "dramatically curtailed" to staunch its losses. One must recognize, however, that weak or unprofitable firms are rarely sold quickly and without further loss. Continental required nearly two years to sell First Options after making the decision to divest and, even then, could do so only on terms highly favorable to the buyer. Losses of subsidiaries that occur during such periods are borne by the parent institution, even after the subsidiary becomes insolvent and regardless of whether the parent bank provides further financing. In the case of First Options, Continental Bank lost over twice the amount of its investment in the subsidiary, and the bank continued to take write-downs even after the subsidiary, booked as a business held for sale, was deconsolidated for financial reporting purposes.

Simply asserting that a bank "must" remain well capitalized won't make it so. Particularly in today's markets, institutions can suffer large losses quickly. These losses cannot be averted or limited by quick sales of troubled businesses, or, as shown in the Continental/First Options case, the sale of troubled operating subsidiaries. Moreover, regulatory definitions will not change the effect that a troubled operating subsidiary will cause for its parent bank. Subsidiaries of banks have traditionally been treated as part of the bank, by bank management and supervisors, and consolidated into the parent bank by generally accepted accounting principles. We should not forget that constructing artificial regulatory capital measures that are inconsistent with economic reality was a major contributing factor to the nation's costly experience with thrifts.

The Comptroller's footnote reference to a regulator's enhanced ability to impose large financial fines to enforce safeguards seems hardly an appropriate solution to a weak institution in a period of market stress. Bank supervisors must consider the financial resources of a bank in assessing fines; it would be contrary to the best interests of the Bank Insurance Fund—and, ultimately, the taxpayer—to impose penalties that jeopardize a bank's viability. The far better approach is to avoid the situation altogether.

Regardless of any intended safeguards or regulatory measures of capital adequacy, market participants will recognize that the subsidiary *and* its parent bank have suffered an economic loss—a loss of capital on which many bank customers and counterparties had previously relied. Indeed, a subsidiary's loss may also lead to a lower market opinion of bank management, much more so than if the loss had been in an affiliated (not subsidiary) company.

In the late 1980s and early 1990s, the Federal Reserve gained experience with capital maintenance and deduction requirements in its dealings with certain savings and commercial banks engaged in real estate development activities either directly, or through operating subsidiaries. In these situations, the parent holding companies were

required to maintain their capital ratios and those of their subsidiary banks, after deducting all equity investments and extensions of credit to real estate projects and to participants in those projects.

As the condition of these institutions deteriorated, the results were much as we have described. Many of them could not comply with imposed limits, and attempts to resolve their problems did not always succeed. They were often unable to raise capital, sell their subsidiaries, or obtain replacement funding from third parties. While we recognize that no one is proposing to permit real estate development in operating subsidiaries, we believe that this experience highlights the practical difficulty of insulating a bank from loss arising in the bank's chain of ownership.

In closing, I would emphasize, once again, that no regulatory framework can *fully* protect an insured bank from problems of its affiliates or subsidiaries. But the holding company approach provides *greater* protection than does an operating subsidiary structure. Financial markets will look through any regulatory construct and examine the economic facts. Losses of a bank's operating subsidiaries *directly* affect the bank's economic strength; losses of its affiliates do not.

Indeed, as activities of financial holding companies expand under H.R. 10 beyond traditional banking activities or those "closely related to banking," it is quite likely that banks in the future will be more willing and able than they are now to separate themselves from problems of their nonbank holding company affiliates if conditions become sufficiently severe. Because of the ownership structure, market assessments, and accounting effects, that alternative is far *less* available in the case of operating subsidiaries. When the federal safety net is involved, why take this greater and unnecessary risk?

Our objective in changing the law to allow financial modernization should be to select an approach that accomplishes the goals of financial modernization in a manner that is consistent with the safety and soundness of our banking institutions and financial system. We should not select a structure, such as the operating subsidiary approach, that has failed the taxpayer and the deposit insurance system in the past.

I hope you find this response helpful. Please contact me if I can be of any further assistance.

Sincerely,

DEPARTMENT OF THE TREASURY

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TREASURY SECRETARY ROBERT E. RUBIN
HOUSE COMMITTEE ON BANKING AND FINANCIAL SERVICES

Mr. Chairman, Members of this Committee, I appreciate the opportunity to discuss the Administration's views on financial modernization, including HR 10, and HR 665, introduced this week by Mr. LaFalce.

Mr. Chairman, as we approach financial modernization legislation, the Administration's overall objective has always been to do what best serves the interests of consumers, businesses and communities, while protecting the safety and soundness of our financial system. We will support legislation that achieves those aims.

Let me begin by noting that the U.S. financial system is stronger and more competitive than ever Abroad, the United States is dominant in investment banking and highly competitive in other segments of financial services. U.S. commercial banks are more competitive today than at any time I can remember. The problem our financial services firms face abroad is more one of access, than lack of competitiveness.

Financial modernization is occurring already in the marketplace through innovation and technological advances. With the lessening of regulatory barriers, financial services firms are offering customers a wide range of financial products. Banks and securities firms have been merging; banks are selling insurance products; and insurance companies are offering products that serve many of the same purposes as banking products -- all of which increases competition and thus benefits consumers.

Financial modernization will continue in the absence of legislation, but it can, with good legislation, occur in a more orderly fashion. Treasury has long believed in the benefits of such legislation, but we have also been clear that if this is going to be done, it needs to be done right

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Let me also say that while we favor financial modernization legislation, it does seem to me that when you look at the developments around the world over the last couple of years, and when you look at the size of mergers here in the United States over the same period, there are legitimate concerns about financial modernization with respect to economic concentration and systemic risk.

Let me turn now to the bills before this committee. Both bills, HR 10 and HR 665, take the fundamental actions necessary to modernize our financial system by repealing the Glass-Steagall Act's prohibitions on banks affiliating with securities firms and repealing the Bank Holding Company Act prohibitions on insurance underwriting. Beyond that, however, there are significant differences between the two bills.

Today, I would like to focus on the Administration's concerns about HR 10. As you know, the Administration would have vetoed HR 10 had it passed in the last Congress, and we continue to oppose HR 10 in its current form. We have three basic objections to this bill – its prohibition of the use of subsidiaries by banks, its weakening of the effects of the Community Reinvestment Act (CRA), and its expansion without reform of the Federal Home Loan Bank System.

First, the bill would prohibit financial services firms that include banks from conducting new financial activities through bank subsidiaries -- and force them to conduct those activities exclusively through bank holding company affiliates. Subsidiaries and affiliates are absolutely identical with respect to the ability of a bank to transfer any subsidy that may exist in the bank. And subsidiaries and affiliates are absolutely identical with respect to safety and soundness – except in one respect, which I will discuss in a moment, in which subsidiaries are actually superior with regards to banks' safety and soundness. The LaFalce bill, which allows banks to conduct merchant banking and securities activities through a subsidiary, contains the following rigorous safeguards that produce this result:

- Every dollar a bank invests in a subsidiary would be deducted from the bank's regulatory capital, just as is the case with every dollar a bank pays as a dividend to its parent holding company for investment in an affiliate. A bank would have to be well-managed and well-capitalized before and after such investment is deducted from its capital and on an ongoing basis.

- A bank could not invest any more in a subsidiary than it could pay as a dividend to its parent holding company for investment in an affiliate.

- The rules governing loans from a bank to a subsidiary would be exactly the same as they are for a loan from a bank to an affiliate.

Thus, there are no public policy reasons to deny the choice of a subsidiary; however, there are four important policy reasons to allow that choice.

First, financial services firms should, like other companies, have the choice of structuring themselves in the way that makes the most business sense and this, in turn, should lead to better service and lower costs for their customers.

Second, the relationship between a subsidiary and its parent bank provides a safety and soundness advantage. Firms that choose to operate new financial activities through subsidiaries are, in effect, keeping those assets available to the bank rather than transferring them outside the bank's reach. If the bank ever needed to replenish its capital, the bank's interest in the subsidiary could be sold solely at the behest of the bank. If the bank were ever to fail, the FDIC could sell the bank's interest in the subsidiary in order to protect the bank's depositors and the deposit insurance fund. For this reason, the FDIC, a neutral observer with a paramount interest in this issue, its current chairman and three former chairmen -- two Democrats and two Republicans -- have stated that the subsidiary option is actually *preferable* from the standpoint of safety and soundness and protecting deposit insurance funds. I would also like to observe that currently, under the Federal Reserve's jurisdiction, foreign banks underwrite and deal in securities through subsidiaries in the United States, and U.S. banks conduct securities and merchant banking activities abroad through so-called Edge Act subsidiaries.

Third, to the extent that firms choose to operate through subsidiaries, the consolidated assets of the bank will be larger than if these activities are conducted through affiliates, and that, in turn, is favorable with respect to the Community Reinvestment Act

Fourth, one of an elected Administration's critical responsibilities is the formation of economic policy, and an important component of that policy is banking policy. In order for the elected Administration to have an effective role in banking policy, it must have a strong connection with the banking system. That connection is currently provided by the Office of the Comptroller of the Currency, which regulates national banks. We believe if subsidiaries of national banks cannot be used to engage in new activities, then gradually banks will gravitate away from the national banking system, and this critical connection will be lost.

We also believe it is very important that the Federal Reserve Board maintain its strong connection with the banking system. We believe that allowing banks the choice of conducting non-bank financial activities, either through an operating subsidiary or an affiliate, serves the purpose of having both the elected Administration and the Federal Reserve strongly involved in banking policy.

With respect to the subsidiary option, we support three additional steps.

First, we proposed last year -- and the LaFalce bill includes -- joint Federal Reserve-Treasury rulemaking to define new financial activities. We believe that this arrangement would promote consistency and would eliminate the potential for unhealthy competition or laxity in defining new activities.

Second, we favor functional regulation. We support provisions like those in the LaFalce bill, making clear that securities and insurance regulators have the same jurisdiction over subsidiaries as over affiliates.

Third, we have no objection to requiring the largest banks to retain a bank holding company, thereby assuring the Federal Reserve a central supervisory role regardless of whether the bank operates with affiliates or subsidiaries.

Our second major objection to HR 10 is its effect on the Community Reinvestment Act

CRA encourages a bank to serve creditworthy borrowers throughout communities in which it operates. Since 1993, a greatly invigorated CRA has been a key tool in the effort to expand access to capital in economically distressed areas and to make loans to rebuild low and moderate income communities. In fact, since 1993, the number of home mortgage loans extended to African Americans increased by 58 percent, to Hispanics by 62 percent, and to low- and moderate-income borrowers by 38 percent, figures all well above the overall market increase.

We believe that any bank seeking to conduct new financial activities should be required to achieve and maintain a satisfactory CRA record. The LaFalce bill includes that requirement, which we support. Although HR 10 requires a bank to have a satisfactory CRA record when it commences new financial activity, it does not require that the bank maintain a satisfactory record. If we wish to preserve the relevance of CRA at a time when the relative importance of bank mergers may decline and the establishment of non-bank financial activities will become increasingly important, the authority to engage in newly authorized activities should be connected to a satisfactory CRA performance.

Our third major objection to HR 10 relates to the Federal Home Loan Bank System. The FHLBank System is currently the largest issuer of debt in the world. Last year, it issued approximately $2.2 trillion in debt, and it currently has $350 billion in debt outstanding. Yet the System uses little of its government-subsidized debt to further the System's home ownership purpose. We recognize the desire of many Members to see the System lend more to community banks. Indeed, we believe that the System should focus on such lending, not on using taxpayer funds for arbitrage activities and overnight lending which currently constitute so much of its activities. Changing this important System perhaps should be done separately. But if it is to be addressed in this legislation, we believe changes in the FHLB System should occur only in the context of comprehensive reform.

Let me mention briefly two other areas of HR 10 where we have concerns. First, we believe that current law on bank insurance sales is pro-competition and pro-consumer and is preferable to HR 10's provisions, especially with respect to establishing safe harbors and restricting deference. Second, although creating wholesale financial institutions may be an appropriate step, we believe that developments in financial markets over the last year raise serious concerns. We need to consider carefully the consequences of giving them certain of the same benefits of the federal safety net for banks -- the payment system and the discount window, albeit not deposit insurance -- while subjecting them to diminished banking regulation.

Before concluding, I would like to say a few words about HR 665, the LaFalce bill. As I announced on Wednesday, we support the LaFalce bill. The LaFalce Bill allows firms the subsidiary option, preserves CRA, avoids anticompetitive restrictions on bank insurance sales, and omits other provisions of HR 10 that in our opinion do not advance the cause of modernization. However, we support this bill with the caveat that we have serious concerns about the affiliation between commercial firms and depository institutions which this bill would permit.

Mr. Chairman, let me reiterate: our nation's financial institutions are strong and highly competitive, both here and abroad. In our view, financial modernization legislation can produce significant benefits, but the job must be done right. We in the Administration look forward to working with you and others in Congress to construct good financial modernization legislation that serves the interests of consumers, businesses and communities, while protecting the safety and soundness of our financial system. Thank you very much.

Questions of Congresswoman Sue Kelly for Secretary Rubin

Question 1:

Secretary Rubin, can you support any type or size of a commercial basket in a financial services modernization initiative? If yes, what size would be acceptable?

I have serious reservations about allowing affiliations between depository institutions and commercial firms At a time when recent financial market events give reason for caution about mixing banking and commerce, provisions authorizing a commercial basket would head in the wrong direction. Recent experience in Asia raises concerns that mixing banking and commerce can lead to inefficient allocation of resources and exposure of the banking system to excessive risks

Question 2:

Yesterday we heard from Chairman Greenspan. He was very concerned that any merchant banking activities, no matter the regulation or regulators, should be allowed because of the risk to the taxpayer through the subsidy of FDIC insurance to the bank. How do you respond to these concerns?

H.R. 10 already authorizes merchant banking for affiliates of banks. H.R. 665 and the Treasury would allow a subsidiary *or* an affiliate to engage merchant banking, subject to functional regulation and a rigorous set of safety and soundness safeguards.

With the safeguards provided in H.R. 665, any risks from new activities to bank safety and soundness would be no greater if conducted in a subsidiary than in an affiliate, and in certain respects the subsidiary structure would provide greater protection than the affiliate structure to banks, the deposit insurance funds, and taxpayers. Furthermore, subsidiaries and affiliates are absolutely identical with respect to the ability of a bank to transfer any subsidy that the bank may derive from deposit insurance and other aspects of the federal safety net

Question 3:

Chairman Greenspan spoke of an example of First Options, an operating subsidiary of Continental. He informed us that the assets contained in that op sub were lost so quickly that none of the safety and soundness precautions had a chance to take effect. How do you respond to the risk demonstrated by this example?

First Options of Chicago, a subsidiary of Continental Illinois National Bank, suffered significant trading losses during the 1987 market crash. Continental Illinois incurred no losses over and above its investment in and loans to First Options -- even though there were then significantly fewer restrictions on a bank's dealings with its subsidiary than would be imposed by H.R. 665

H.R. 665 and the Committee Print to H.R. 10 would expressly limit the amount a bank could invest in, or lend to, its subsidiary These limitations are much more restrictive than those that were in place for Continental Illinois in 1987

First Options was a registered broker-dealer and futures commission merchant. It executed and cleared trades on securities and commodities exchanges, and made margin loans to market participants.

First Options experienced liquidity problems on the day of the stock market crash of October 19, 1987 On October 20, in violation of OCC-imposed restrictions on its investments in and loans to First Options, Continental Illinois made a loan of $130 million to First Options. The OCC learned of the loan immediately, and immediately initiated enforcement action. The next day, the loan was repaid by the bank holding company.

First Options did not fail. It was sold by Continental Illinois in 1991.

The 1976 case of Hamilton National Bank and its mortgage lending *affiliate* provides an interesting parallel to First Options The affiliate had originated more than $200 million in loans, funded by commercial paper issued by the bank holding company Because of market concerns about real estate exposure, the holding company had difficulty rolling over its commercial paper. As a result, the mortgage affiliate increased its loan sales to the lead bank, Hamilton National Bank in order to raise funds. The poor quality of those loans ultimately caused the bank to fail *At the time of failure, 87 percent of the bank's problem loans had come from its mortgage banking affiliate* In the wake of the Hamilton failure, lending limits to affiliates were amended to include asset purchases. Under H.R. 665 and the Committee Print to H.R. 10, those limits would protect banks from affiliates and subsidiaries alike.

Question 4:

It is my understanding that in the LaFalce op sub approach that you support the Treasury to be the interpreter and enforcer of section 23 (a) of the Federal Reserve Act. Why is it necessary that the Treasury to have this power?

We have not sought that authority.

Question 5:

It is my understanding that the Edge Act allows for the use of only 40 percent of total equity in a U.S. bank op sub operating abroad to be used for merchant

banking. This seems to be operating well for U.S. banks operating abroad. Would you accept the 40 percent limitation for merchant banking activities for the op subs proposed in this bill?

No. Currently, merchant banking is not a permissible activity for affiliates of banks. If financial modernization is to authorize that activity for affiliates of banks, our position is that it should also be authorized for subsidiaries of banks, subject to the rigorous safety and soundness protections that I outlined in my testimony

Question 6:

I was wondering if you could let me know which Federal Home Loan Bank proposal is more acceptable to you: the proposal that passed the House last year or the current proposal before us in this new version of H.R. 10? Please explain why?

We do agree with some of the FHLBank provisions contained in both versions of H.R 10. However, neither proposal takes any meaningful steps to resolve the two most fundamental issues involving the FHLBank System.

The first critical problem in the System is its investment portfolio, which currently totals over $140 billion and does nothing to further the System's mission Any bill aimed at reforming the System must address this serious problem through specific, objective limits on the System's investments.

The second critical problem is strengthening the nexus between FHLBank advances and the System's public purpose of providing liquidity for housing finance. There is currently no assurance that FHLBank advances will actually be used to finance housing, and advances have generally ceased to be a vital source of liquidity for home lenders and have instead become a government-subsidized source of funds for practically any depository institution

We believe that both of these fundamental issues must be addressed in any legislation reforming the FHLBank System, therefore we do not support the FHLBank proposals contained in either last year's House-passed version of H.R. 10 or the new version of H.R. 10

SUBSIDIARIES v. AFFILIATES:

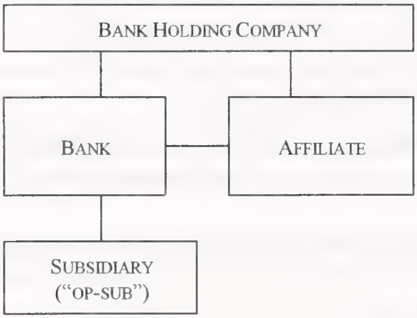
QUESTIONS AND ANSWERS

February 11, 1999

QUESTION | PAGE

1. ***What's the difference between a subsidiary and an affiliate of a bank?***

A "bank holding company" is a company that owns a bank. (For tax and other reasons, most U.S. banks are owned by holding companies.) An "affiliate" of a bank is a separately incorporated entity owned by the same bank holding company. A "subsidiary" of a bank is a separately incorporated entity owned by the bank itself



To a customer, or even a financial analyst, affiliates and subsidiaries are generally indistinguishable. Each can share employees with the bank. Each can have reporting lines that overlap with those of the bank. Each can operate under the same risk management and strategic planning system as the bank. For public financial reporting purposes, each typically has its assets and liabilities consolidated with those of the bank in the holding company's consolidated financial statements.

For a financial services firm that includes a bank, the affiliate and subsidiary structures are both reasonable options. Thus, for example, many such firms operate mortgage companies as affiliates of banks, while many others operate them as subsidiaries of banks

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2. ***What's the Treasury's position on allowing subsidiaries to engage in financial activities?***

We would allow a subsidiary or an affiliate to engage in any financial activity—subject to functional regulation and a rigorous set of safety and soundness safeguards.

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3. ***Would the risks of activities conducted in a subsidiary adversely affect the safety and soundness of the parent bank?***

Under a fundamental, longstanding, and uniform rule of corporate law, a parent corporation is not liable for the obligations of a separately incorporated subsidiary. If the subsidiary fails, the parent stands to lose no more than its investment in the subsidiary. The parent can be held liable for the obligations of a subsidiary—through a process known as "piercing the corporate veil"—only under extraordinary circumstances, such as fraud by the parent.

The Treasury would impose rigorous safeguards on a bank's exposure to a subsidiary engaged in new financial activities (as would H.R. 665, the LaFalce bill).

- The bank would have to remain well-capitalized (i.e., in the highest regulatory capital category) and well managed, and would face sanctions if it failed to do so.

- Every dollar of the bank's equity investment in the subsidiary would be deducted from the bank's capital—and the bank would have to remain well-capitalized even after the deduction. Thus, even if the subsidiary were to fail and the bank's equity investment in it were to prove a total loss, the bank would still be well-capitalized. The capital-deduction rule would, in effect, require the bank to be able to lose its entire equity stake in the subsidiary and still remain well-capitalized.

- A bank could not make an equity investment in a subsidiary that would exceed the amount that the bank could pay as a dividend.

- Sections 23A and 23B of the Federal Reserve Act would be amended to restrict any loans or other extensions of credit from the bank to the subsidiary, any guarantees by the bank for the benefit of the subsidiary, and any purchase of assets by the bank from the subsidiary. Thus the total amount of these transactions with the subsidiary could not exceed 10 percent of the bank's capital, and the total amount of these transactions with all of the bank's subsidiaries and affiliates combined could not exceed 20 percent of the bank's capital. All such transactions between the bank and the subsidiary would have to be on market terms and fully secured by specified types of high-quality collateral.

Under these safeguards, there would be *no economic difference* between conducting an activity in a subsidiary and conducting it in an affiliate—apart from such benefits of the subsidiary as providing greater protection to the FDIC and diversifying the bank's earnings (as explained in response to Question 4)

- The rules governing extensions of credit, guarantees, and asset purchases would be *exactly the same* for subsidiaries as for affiliates.

- The rules governing equity investments would be *equivalent*. A bank could invest in a subsidiary only the amount that it could pay as a dividend (e g , to its parent holding company) And the bank would have to deduct from its own capital the entire amount of the investment. Thus, if the bank made an equity investment in a subsidiary, the economic result would be the same as if the bank had paid a dividend to its parent holding company and the holding company had invested the proceeds in an affiliate In either case, the amount invested would no longer count as part of the bank's capital.

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4. How would allowing new financial activities in subsidiaries affect the federal deposit insurance funds?

Allowing new financial activities in subsidiaries would help protect the deposit insurance funds For the reasons noted in response to Question 3, allowing new financial activities in subsidiaries would pose no greater risk to banks than allowing them in affiliates And it would actually *increase the good assets available to the FDIC to resolve troubled banks and protect their insured depositors*—whereas forcing activities into affiliates would tend to decrease those assets A bank's ownership interest in a subsidiary is an asset of the bank. If the bank gets into trouble, the bank can sell its stake in the subsidiary and use the proceeds to replenish its regulatory capital. And if the bank fails, the FDIC can sell the bank's stake in the subsidiary and use the proceeds to reduce any loss that the FDIC would otherwise incur in protecting the bank's insured depositors By contrast, the FDIC generally has no authority to sell assets of a failed bank's nonbank affiliates.

The FDIC, which has a paramount interest in protecting the deposit insurance funds, has emphasized that the subsidiary structure better protects bank safety and soundness. Chairman Helfer of the FDIC testified in 1997:

> "From a safety and soundness standpoint, both the holding company model and the bank subsidiary model are viable approaches to expanding the powers of banking organizations. The safeguards that are necessary to protect the insurance funds are similar for either structure. If these safeguards are in place and enforced, either approach will work to protect the insured bank and the deposit insurance funds.
>
> "[A]llowing banks to generate earnings from activities in bank subsidiaries lowers the probability of failure Earnings from bank subsidiaries provide greater protection for the insurance funds than do earnings from activities in bank holding company

affiliates, because the earnings of the subsidiary accrue to the benefit of the insured bank parent. This is because diversification often leads to less volatile earnings."[1]

FDIC Chairman Tanoue likewise emphasized the value of the subsidiary: When the bank "is financially troubled and the affiliate/subsidiary is sound, the value of the subsidiary serves to directly reduce the exposure of the FDIC. Thus, the subsidiary structure can provide superior safety and soundness protection."[2]

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5. Insofar as a bank may receive a federal subsidy through deposit insurance and the payment system, could the bank transfer the subsidy more readily to a subsidiary than to an affiliate?

No. The safety and soundness protections described above (Question 3) would eliminate any economic difference between conducting an activity in a subsidiary and conducting it in an affiliate (apart from such benefits of the subsidiary as better protecting the FDIC and diversifying the bank's earnings). Thus, if a subsidy exists, the bank could not transmit it any more readily to a subsidiary than to an affiliate. Every dollar that the bank could invest in a subsidiary could as readily be paid out as dividends to the holding company in order to capitalize new affiliates. (And the limits on a bank's loans, guarantees, and asset purchases would be exactly the same for a subsidiary as for an affiliate.) There is no evidence that money paid upstream to affiliates would carry any less of a subsidy than the same funds invested downstream in an subsidiary.[3] And the bank's ability to provide such funds would be the same for affiliates as for subsidiaries: the bank could not make an equity investment in a subsidiary that exceeded the amount it could pay in dividends; and the bank would have to remain well-capitalized after deducting the capital invested in the subsidiary or channeled as dividends to the holding company.

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[1] Testimony of Ricki Helfer, Chairman, FDIC, Committee on Banking and Financial Services, U.S. House of Representatives, May 22, 1997.

[2] Testimony of Donna Tanoue, Chairman, FDIC, Committee on Banking, Housing, and Urban Affairs, United States Senate, June 25, 1998.

[3] The Federal Reserve has argued that dividends paid by banks have largely ended up in the hands of shareholders (as holding company dividends), rather than being used to capitalize new affiliates. But this does not indicate what would happen if bank holding companies could have broad new activities and affiliations. If a material safety net subsidy existed and could be transmitted, holding company management would have strong incentives on behalf of shareholders to utilize bank resources to capitalize new affiliates.

A recent article published in the Federal Reserve Bank of Richmond's *Economic Review* notes that the bank could transfer subsidized funding to the affiliate as follows:

> "Banks could pass along subsidized funding through dividend payments. Here's how. A bank could gather funds at subsidized rates and pass them to its affiliates and subsidiaries by paying dividends to the parent [bank holding company]. The parent might then pass the funds on to bank affiliates and subsidiaries by purchasing debt of these entities or through equity investments in them. In this way funds raised at subsidized rates could leak out to affiliates and subsidiaries and be substituted by the affiliate for more expensive, unsubsidized funding sources.
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> " . . While . . limits [on dividend payments] might somewhat restrict the efficacy of dividends as a means of subsidy transfer, they cannot completely forestall such use. For a bank that is larger than its affiliated nonbank, the [applicable limit] may amount to a large portion of the nonbank's liabilities. Consequently, the bank could provide a significant share of the affiliate's funding."[4]

One might question whether a net subsidy of any significance actually exists:

- If a measurable subsidy existed, firms that include banks would tend to locate activities under the bank to reap a competitive advantage. Yet where such firms are free to choose their organizational form, no clear pattern emerges.
    - For example, mortgage banking operations can be conducted in the bank, in subsidiaries of the bank, or in holding company affiliates. Of the top 20 bank holding companies, 6 currently conduct mortgage banking activities in an affiliate, 9 conduct such activities in the bank or in a subsidiary of the bank, and 5 use a combination of bank and affiliate. This pattern suggests either that any net subsidy is minimal, or that it is the same for both sorts of organizational arrangements.

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[4] Walter, John R., "Can a Safety Net Be Contained?," Federal Reserve Bank of Richmond *Economic Quarterly*, Volume 84/1 Winter 1998, p. 12

Note that the holding company and its shareholders stand to benefit from any subsidy of the bank regardless of whether the bank ever "transfers" that subsidy anywhere else. Shareholders can accept a smaller return from the holding company's investments in units not funded by the bank in exchange for a higher return on the holding company's investment in the bank.

- In addition, if a safety net subsidy were substantial and created a competitive advantage, banks (even more than their subsidiaries) would tend to dominate the market in activities that they can conduct within the bank. But this has not been the case. For example, banks do not dominate the government securities markets, even though banks are free to underwrite and deal in those securities.

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6. Would generally accepted accounting principles lead banks to prop up troubled subsidiaries?

Banks do submit "call reports" to regulators that consolidate the bank's financial statements with those of its subsidiaries, as generally required under GAAP. But accounting principles do not determine a bank's exposure to a subsidiary and do *not* justify limiting the subsidiary's activities.

- *Accounting does not dictate liability.* A parent corporation is not generally liable for the obligations of a subsidiary (as discussed above in connection with Question 3)—regardless of whether the assets of the parent and subsidiary are consolidated for accounting purposes.

- *The most heavily relied upon, publicly reported GAAP-based financial statements are those of the bank holding company,* which consolidate the financial statements of the bank with those of all affiliates as well as all subsidiaries. *Thus if banks have a GAAP-induced incentive to prop up subsidiaries, banks have the same incentive to prop up affiliates*, and bank holding company financial statements that reflect an affiliate's poor performance could just as easily concern investors and depositors.

- Although it is true that losses of a subsidiary would appear in a bank's GAAP-based financial statements, these losses would disappear from the bank's balance sheet when the subsidiary was liquidated or sold. At that point, the bank's financial statements would again reflect its actual economic loss, which would not exceed the bank's equity investment (for which it has already taken a capital deduction and still remained well-capitalized) and credit exposure within section 23A limits.

- Regardless of a bank's inclination to support a troubled subsidiary, the Treasury's approach would constrain the bank from doing so. The bank could not make any equity investment without deducting that investment from its own capital and remaining well-capitalized after the deduction. As required by amended sections 23A and 23B, any loan, guarantee, or asset purchase would have to be fully collateralized and on market terms, and could not exceed 10 percent of the bank's capital.

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7. ***Are some proposed financial activities so inherently risky as to be inappropriate for subsidiaries?***

The notion that banks conduct safe "banking" activities whereas other financial service providers conduct dangerous "nonbanking" activities is antiquated, as Chairman Greenspan has explained:

> "[T]he pressures unleashed by technology, globalization, and deregulation have inexorably eroded the traditional institutional differences among financial firms. . . . On the bank side, the economics of a typical bank loan syndication do not differ essentially from the economics of a best-efforts securities underwriting. Indeed, investment banks are themselves becoming increasingly important in the syndicated loan market. With regard to derivatives instruments, the expertise required to manage prudently the writing of over-the-counter derivatives, a business dominated by banks, is similar to that required for using exchange-traded futures and options, instruments used extensively by both commercial and investment banks. The writing of a put option by a bank is economically indistinguishable from the issuance of an insurance policy. The list could go on. It is sufficient to say that a strong case can be made that the evolution of financial technology alone has changed forever our ability to place commercial banking, investment banking, insurance underwriting, and insurance sales into neat separate boxes."[5]

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8. ***Do American banks have experience conducting nonbanking activities through subsidiaries?***

Yes. Subsidiaries of U.S. banks have for years engaged overseas in investment banking and merchant banking—safely, soundly, and with Federal Reserve approval.[6]

These subsidiaries, which operate under the Edge Act, can be extremely large. For example, one such subsidiary has over $73 billion in assets, or approximately 28 percent of the total assets of the bank and its subsidiaries.

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[5] Remarks by Chairman Alan Greenspan at the Annual Convention of the American Bankers Association, Boston, Massachusetts, October 5, 1997.

[6] Since 1979, the Fed's Regulation K has permitted foreign subsidiaries of both U.S. banks and bank holding companies to underwrite and deal in *equity* securities outside the United States. Foreign subsidiaries of U.S. banking organizations have, for over 25 years, had broad authority to underwrite and deal in *debt* securities.

Overseas subsidiaries are subject to less stringent safeguards than the Treasury would apply to U.S. subsidiaries of banks. The Fed generally does not apply to Edge Act subsidiaries the restrictions of sections 23A and 23B (such as the 10 and 20 percent limits described above in response to Question 3), and H.R.10 would continue that practice. Thus a bank's loans to an Edge Act subsidiary could exceed 100 percent of the bank's capital.[7]

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9. Did the thrift debacle result from allowing new financial activities in subsidiaries?

The thrift debacle had multiple causes, and resulted in part from allowing insolvent or weakly capitalized insured depository institutions to expand rapidly into risky new activities for which they had little or no experience (including nonfinancial activities like real-estate development). Far from having to remain well-capitalized, thrifts faced no effective capital discipline, and were commonly in poor financial condition. No capital deduction requirement applied. Since thrifts had little or no real capital of their own, they essentially funded their investments with insured deposits. And far from being well-managed, thrifts were ill-equipped to manage the risks involved.

By contrast, under the Treasury's approach a bank must deduct from its own capital its entire equity investment in a subsidiary, and must remain well-capitalized even after the deduction. In effect, the bank must fund every dollar invested in the subsidiary with money that could otherwise go to its own shareholders. And the bank must remain well managed, which includes having internal controls adequate for the risks it faces.

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10. Do bank holding companies face higher borrowing costs than their banks?

A bank holding company's debt generally has a lower credit rating than comparable debt issued by the banks owned by that holding company. Thus the holding company faces correspondingly higher borrowing costs than its banks. Some cite these differences as proof that the bank cannot transfer any safety net subsidy to the holding company. But the differences prove nothing of the sort. We have already explained (in response to Question 5) why a bank can transfer any subsidy just as readily to an affiliate (or holding company) as to a subsidiary. And, as we will now explain, the differences in credit ratings and borrowing costs reflect the typical bank holding company's reliance on its banks' assets and earnings—and its vulnerability to any regulatory action curtailing the bank's dividends.

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[7] Some restrictions do apply. For example, certain portfolio investments could not exceed the bank's tier 1 capital. 12 C.F.R. § 211.5(b)(iii)(A)(2). Certain commitments to underwrite equity securities could not exceed specified percentages of capital, and the bank would have to be able to remain well-capitalized after deducting from its capital commitments exceeding those limitations. 12 C.F.R. § 211.5(d)(14)(ii).

A holding company with debt outstanding commonly relies on dividends from the bank for the cash it needs to service that debt. If the bank gets into financial trouble, regulators often curtail dividend payments by the bank.[8]

The credit rating and cost of holding company debt reflect the additional risk of such a dividend cut-off. They also reflect the inferior position of holding company debt if the bank fails. In any such failure, holding company debt holders would be paid only out of money remaining after the FDIC, uninsured depositors, and all other creditors of the bank were paid in full.[9]

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11. Is allowing new financial activities in subsidiaries consistent with functional regulation?

Absolutely. We support nondiscriminatory functional regulation of securities and insurance activities (as under H R. 665), regardless of whether these activities are housed in subsidiaries or affiliates of banks. The SEC would have the same authority over a broker-dealer that was a subsidiary of a bank as it would over a broker-dealer affiliate of a bank holding company. State insurance commissioners would have the same authority over an insurance company owned by a bank as they would over any insurance company owned by the bank's parent holding company.

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12. What about the risk of a future Congress loosening applicable safeguards?

Any such risk would be no greater in the case of subsidiaries than in the case of affiliates.

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[8] Moreover an undercapitalized bank cannot pay dividends at all 12 U.S.C § 1831o(d)(1)(A)

[9] By contrast, debt holders of the *bank*, although they would be paid only after the FDIC and other depositors, would be on a par with most of the bank's remaining creditors.

TESTIMONY OF

DONNA TANOUE
CHAIRMAN
FEDERAL DEPOSIT INSURANCE CORPORATION

ON

H.R. 10, FINANCIAL SERVICES ACT OF 1999

BEFORE THE

COMMITTEE ON BANKING AND FINANCIAL SERVICES
UNITED STATES HOUSE OF REPRESENTATIVES

10:00 A.M.
FEBRUARY 12, 1999
ROOM 2128, RAYBURN HOUSE OFFICE BUILDING

Mr. Chairman, Mr. LaFalce, and members of the Committee, I appreciate this opportunity to present the views of the Federal Deposit Insurance Corporation (FDIC) on H.R.10, the Financial Services Act of 1999, and related issues. I commend you, Mr. Chairman, for acting quickly in the 106^{th} Congress and beginning formal deliberations on how best to strengthen and improve the financial services industry. H.R. 10 represents a positive legislative initiative with which to proceed in this important endeavor.

The FDIC has been and remains supportive of efforts to modernize the nation's banking and financial systems. Since its creation under the Banking Act of 1933, the FDIC has worked to ensure the safety and soundness of the banking system and to assure depositors that their insured deposits are safe. Consistent with its broad perspective on public-policy issues, this concern for the safety and soundness of insured depository institutions underscores the FDIC's approach to financial modernization.

The financial markets have changed dramatically since the 1930s when many of our nation's laws governing the financial system were written. Improvements in information technology and innovations in financial markets have rendered the current system increasingly obsolete and unable to provide the full range of financial services required by businesses and individual consumers in today's global economy. Modernization of the financial system is not only desirable, but necessary, to enable the financial services industry to meet the challenges that lie ahead.

The FDIC has long held the view that the maintenance of healthy and viable depository institutions requires that these institutions generate sufficient returns to attract new capital in

support of normal growth and expansion into new areas. To achieve these goals, insured depository institutions must have the ability to compete on an equitable basis with other business enterprises, and their products and services must be permitted to evolve with the marketplace in a manner consistent with safety and soundness. Equally important, the legitimate needs of consumers must be addressed. As part of any effort to modernize the financial system, the potential effect on small communities, isolated markets, and customers of insured depository institutions must be considered.

H.R. 10 repeals key Glass-Steagall restrictions and authorizes holding companies and other affiliates of banks to engage in a wider range of securities and insurance activities. These represent important steps toward achieving the goals of financial modernization. In addition, I commend you, Mr. Chairman and the co-sponsors of H.R. 10, for including a repeal of the Savings Association Insurance Fund (SAIF) Special Reserve.

Although H.R. 10 is a significant start toward financial modernization, the FDIC believes it can be improved. First, although H.R. 10 would eliminate the SAIF Special Reserve, it does not mandate a merger of the SAIF and the Bank Insurance Fund (BIF). Second, the proposed legislation unnecessarily favors the holding company affiliate structure over the bank operating subsidiary structure as the means by which banking organizations could expand into new financial products and services. Third, the banking and commerce provisions in the bill do not recognize adequately either the track record of unitary savings-and-loan holding companies in this area or foreign and domestic developments in the financial marketplace. Finally, in

implementing a greater degree of functional regulation, the bill reduces the authority of the federal banking regulators to determine the appropriate products and services of banks.

The Deposit Insurance Funds

H.R. 10 would eliminate the SAIF Special Reserve, and the FDIC applauds this provision. The Special Reserve was created by the Deposit Insurance Funds Act of 1996 (the Funds Act). Under the Funds Act, on January 1, 1999, the FDIC was required to establish a Special Reserve comprised of SAIF funds above the dollar amount required to meet the 1.25 percent Designated Reserve Ratio (DRR) at year-end 1998. The Special Reserve can only be drawn upon if the reserve ratio of the SAIF is less than 50 percent of the DRR and is expected to remain so for four consecutive quarters.

As required by law, the Special Reserve was established on January 1, 1999. On the basis of September 30, 1998 data, approximately $1 billion was segregated into the Special Reserve, thus lowering the SAIF reserve ratio from 1.39 percent to 1.25 percent. The amount of the SAIF Special Reserve will be adjusted to reflect year-end figures when those figures become available in March 1999.

Ironically, if the SAIF Special Reserve is not eliminated, the Special Reserve could lead to an assessment rate disparity between the BIF and the SAIF, thus recreating the very same circumstances the Funds Act – which levied a $4.5 billion special assessment on SAIF-assessable deposits – was intended to eliminate. As a result of the Special Reserve,

unanticipated failures of banks and savings associations, or faster-than-expected growth in insured deposits, could cause the reserve ratio of the SAIF to drop below the DRR. Any drop in the SAIF reserve ratio below the DRR likely would precede the reserve ratio of the BIF falling below 1.25 percent, because the SAIF would be starting at a lower reserve ratio. When a fund's reserve ratio drops below the DRR, the FDIC is required to increase deposit insurance assessments to restore the fund's reserve ratio to the DRR. Thus, the FDIC most likely would be required to raise SAIF assessments before instituting a comparable increase in BIF rates, recreating a rate disparity between the two funds. This disparity in assessment rates could arise even though the actual amount of funds available to support the SAIF, which would include the Special Reserve, might exceed the amount of funds necessary to meet the DRR.

Differences in deposit insurance assessment rates among institutions should reflect differences in risk posed to the insurance funds, not artificial distinctions, such as those that existed before the passage of the Funds Act. Higher assessment rates for SAIF-insured deposits resulted in the shifting of deposits from the SAIF to the BIF and other inefficiencies that were detrimental to virtually all parties. Such market distortions have an economic cost as institutions devote resources to countering artificial statutory distinctions. Thus, the FDIC strongly endorses the elimination of the Special Reserve as outlined in H.R. 10.

Although the Special Reserve is a recent creation, much of H.R. 10 deals with modernizing laws that have become outdated with the passage of time. However, there is one relic of the statutory framework established after the Great Depression that the bill does not address – two separate deposit insurance funds. The arguments for a merger of the BIF and the

SAIF are persuasive, the timing is optimal, and the administrative and logical steps required to bring it about are not complicated or difficult.

The FDIC was established in 1933 and the Federal Savings and Loan Insurance Corporation (FSLIC) was established in 1934. Throughout its history, the FDIC always has insured some savings institutions, notably state-chartered savings banks, but for the most part it has insured commercial banks. The FSLIC insured savings-and-loan associations (S&Ls). The SAIF was established in 1989, in the aftermath of the savings-and-loan crisis of the 1980s and the insolvency of the FSLIC, to succeed the FSLIC fund and the FDIC fund was renamed the BIF. Both funds were put under the management of the FDIC.

In the 1930s, there were substantial differences between commercial banks and S&Ls. In general, S&Ls were mutual institutions that primarily offered savings accounts and home mortgages for consumers. Because their charters permitted limited activities, they were not allowed to offer checking accounts, consumer loans, or commercial loans. Indeed, their loans were virtually all long-term fixed-rate residential mortgages. Commercial banks, on the other hand, served mostly commercial customers. More than two-thirds of bank deposits were demand deposits and banks made very few residential mortgages. Thus, there were significant differences in the institutions insured by the FDIC and the FSLIC when the agencies were created.

Over time, the distinctions between banks and thrifts have become blurred. Each has entered what was once the other's domain. On the asset side, the portfolios of all but the largest

banks often look very similar to the portfolios of thrift institutions. Both offer essentially an identical array of deposit accounts. From the point of view of the insured depositor, there is virtually no difference between banks and thrifts.

Not only have the banking and thrift industries become more similar over time, but the composition of who holds SAIF-insured deposits has changed as well. The name Savings Association Insurance Fund connotes a fund that insures savings associations. When it was established, this was indeed the case. Virtually all SAIF-insured deposits were held by SAIF-member thrifts. However, over the last decade, this has changed dramatically. As of September 30, 1998, commercial banks (35.1 percent) and BIF-member savings banks (8.1 percent) held over 40 percent of all deposits insured by the SAIF. Indeed, two of the five largest holders of SAIF-insured deposits are First Union National Bank and NationsBank N.A. The name Savings Association Insurance Fund has become a misnomer. The SAIF has become a true hybrid fund.

If the only problem with having two insurance funds is that one is misnamed, there would be little reason to merge the funds. However, there are substantive reasons why the two funds should be merged. First, as I have previously stated, the BIF and the SAIF provide an identical product – deposit insurance. Yet, as long as there are two deposit insurance funds, whose assessment rates are determined independently, the prospect of a premium differential exists. When an identical product is offered at two different prices, consumers – in this case, banks and thrifts that pay deposit insurance assessments – naturally gravitate to the lower price. This phenomenon was observed before the passage of the Funds Act when some SAIF-insured institutions successfully shifted deposits to BIF insurance. Despite moratoriums, entrance and

exit fees, and bans on deposit shifting, market forces ultimately prevailed. Inefficiency and waste were introduced as institutions expended time and money trying to circumvent restrictions that prohibited them from purchasing deposit insurance at the lowest price. Although the Funds Act led to the elimination of the premium disparity that then existed between the BIF and the SAIF, a merged fund would guarantee that such a disparity would not recur in the future. It would have a single assessment rate schedule whose rates would be set solely on the basis of the risks that institutions pose to the single fund. The prospect of different prices for identical deposit insurance coverage would be eliminated.

Second, a merger of the funds would help mitigate the increased concentrations of risk facing both the SAIF and the BIF. Since its inception, the SAIF has insured far fewer, and more geographically concentrated institutions than the BIF has insured. Consequently, the SAIF has faced greater long-term structural risks and has been subject to proportionately greater losses from the failure of a single member. Although interstate merger activity may have reduced the geographic concentration of SAIF deposits somewhat, recent merger activity has increased the relative size of the largest members of either fund. As of midyear 1990, the three largest holders of SAIF-insured deposits held 8.7 percent of these deposits, and the three largest holders of BIF-insured deposits held 5 percent of these deposits. As of September 30, 1998, that figure was 13.3 percent for the SAIF and 10.1 percent for the BIF. In a combined insurance fund, the three largest institutions would hold 9.3 percent of insured deposits.

Finally, a merger of the funds also would result in lower administrative costs to the FDIC and to approximately 900 institutions that hold both BIF- and SAIF-insured deposits (Oakar

deposits) that must be tracked and assessed separately. Although these costs may not be large in absolute dollars, they represent wasted funds.

Instead of providing for a merger of the funds, H.R. 10 would require the FDIC to undertake a study of, and report to the Congress on, the adequacy of the deposit insurance funds in light of ongoing consolidation in the industry and the possible merger of the funds. The study must include the FDIC's plans for merging the BIF and the SAIF, as well as an estimate of the costs of a funds merger and how those costs may be passed on to the industry, particularly SAIF-members. The report to the Congress would be due within nine months of enactment.

FDIC staff has examined whether there are significant obstacles confronting the FDIC in effecting a merger of the BIF and the SAIF. The primary goal was to identify any initiatives that should be undertaken by the FDIC to ensure that a merger could be implemented in a timely manner. After considering the broad range of possible legal, accounting, logistical and technical issues that may arise in implementing a merger of the funds, the staff concluded that there were no major obstacles to a timely merger of the insurance funds. Moreover, as noted above, a merger of the funds would reduce the regulatory burden on institutions that hold both BIF- and SAIF-insured deposits and lower administrative costs to the FDIC.

In addition, the FDIC has begun a study of the effects of industry consolidation and megamergers on the risks to the BIF. The study analyzes the probability of the BIF becoming insolvent under various assumptions about the concentration of the banking industry. It includes an analysis of historical trends in consolidation and a review of the differences (in terms of BIF

losses) between large and small banks. The main part of the analysis is a projection of the BIF under various consolidation scenarios, including a future with megabanks. We expect to complete this study by June. However, regardless of its outcome, it is difficult to see how this study could lead one to conclude that the funds should not be merged. Even if the study concludes that megabanks will not appreciably increase the risk to the funds, eliminating the possibility of future premium disparities and eliminating wasteful administrative costs for the FDIC and depository institutions are themselves sufficient reasons to merge the funds. If the study concludes that megabanks have increased risks, that is merely one more reason to merge the funds.

In summary, the BIF and the SAIF both are capitalized fully, with identical assessment rate schedules, and the members of both funds are healthy and profitable. Upon elimination of the SAIF Special Reserve, the reserve ratio of the SAIF would be restored to reflect its true level, and the BIF and the SAIF would have comparable reserve ratios. A merger of the two funds under these circumstances would not result in a material dilution of either fund, and would strengthen the deposit insurance system. This is an excellent time to merge the funds and eliminate a weakness in the federal deposit insurance system. It would be unfortunate if the Congress, while modernizing the rest of our statutes governing the financial services industry, left the anachronism of two deposit insurance funds in place.

Permissible Activities and Corporate Structure

H.R. 10 would repeal key Glass-Steagall restrictions that inhibit member-bank affiliations with securities underwriters and would authorize the creation of financial holding companies (FHCs). These holding companies and their nonbank subsidiaries could conduct a wide range of financial activities, including the full range of insurance and securities activities. These expanded activities could not be conducted by the direct subsidiaries of banks. The new test for permissible activities for an FHC would be "financial in nature or incidental to such financial activities." H.R. 10 would modify the Bank Holding Company Act to include a list of activities that would be so classified.

The bill permits FHCs, but not national banks through their direct operating subsidiaries, to offer, on a limited basis, additional services and products that have not yet been found to be financial in nature. However, the FHC must reasonably believe that such activities are financial in nature. Referred to as a "developing basket," these activities may not exceed 5 percent of any of the following: the holding company's gross revenues; the holding company's total assets; and the holding company's total capital.

The bill would expressly authorize a subsidiary of a national bank to engage in any activity classified as financial in nature, in an agency capacity, but not as principal, with the approval of the Comptroller of the Currency, if the bank and any depository institution affiliates are well-capitalized and well-managed. Additionally, at the time the bank first acquires control or an interest in a subsidiary, in order to conduct the new financial agency activity, the bank and

any affiliated depository institutions must have a satisfactory Community Reinvestment Act (CRA) rating. The bill also would authorize a well-capitalized national bank to underwrite within the bank or in a direct subsidiary of the bank certain limited obligation or revenue bonds on behalf of states or their political subdivisions, including public agencies or authorities.

The FDIC has gone on record as supporting the repeal of the Glass-Steagall restrictions and the expansion of permissible financial activities, subject to proper safeguards to protect the safety and soundness of insured depository institutions and the federal deposit insurance funds. The FDIC also endorses the developing basket provision of H.R. 10 that would allow FHCs to offer products and services that are financial in nature in the estimation of the holding companies. These provisions advance the goals of financial modernization, consistent with safety and soundness. However, there is no reason to withhold from banks the option of conducting the full range of expanded financial activities, including activities conducted as principal, through bank subsidiaries. H.R. 10 should be revised to permit the greatest flexibility and freedom to financial firms in deciding how best to organize themselves.

The question as to whether new activities for financial institutions should be authorized for direct subsidiaries of banks or be conducted only in nonbank subsidiaries of bank holding companies has emerged as one of the more critical issues to be decided in the current debate over financial modernization. Aside from its competitive implications, the resolution of this issue is particularly important because, to a large extent, it will determine the future legal and operational structure of diversified financial service providers in the United States.

The FDIC has studied this issue closely for a long time and it is our judgment that both national and state-chartered banks should have the freedom to choose the corporate structure that best suits their business needs for conducting activities not directly permissible to the bank itself, provided certain safeguards are in place to protect the bank, the safety and soundness of the banking system, consumers, and the taxpayer. The necessary safeguards include: (1) applying principles such as those contained in Sections 23A and 23B of the Federal Reserve Act to transactions between a bank and its operating subsidiary, with the appropriate principles to be determined by the federal banking agencies; (2) requiring that the bank's investment in the operating subsidiary be deducted from regulatory capital; (3) requiring that after this deduction, the bank be well-capitalized; and (4) requiring that the corporate separateness of the bank be protected. In addition, the adoption of real-time reporting requirements should be considered for intracompany transactions under certain conditions, analogous to SEC requirements. With these safeguards in place, we see no compelling public-policy reason to mandate a particular organizational form.

From a safety-and-soundness perspective, both the bank operating subsidiary and the holding company affiliate structures can provide adequate protection to the insured depository institution from the direct and indirect effects of losses in nonbank subsidiaries or affiliates. Some have argued otherwise – that the bank holding company structure provides greater safety-and-soundness protection than does the operating subsidiary structure. As the deposit insurer, we have examined this issue closely and we disagree. Indeed, from the standpoint of benefits that accrue to the insured depository institution, or to the deposit insurer in the case of a bank failure, there are advantages to a direct subsidiary relationship with the bank. The properly

insulated operating subsidiary structure and the holding company structure can provide similar safety-and-soundness protection when the bank is sound and the affiliate/subsidiary is financially troubled. However, when it is the bank that is financially troubled and the affiliate/subsidiary is sound, the value of the subsidiary serves to directly reduce the exposure of the FDIC. If the firm is a nonbank subsidiary of the parent holding company, none of these values is available to insured bank subsidiaries, or to the FDIC if the bank should fail. Thus, the subsidiary structure can provide superior safety-and-soundness protection. Appendix A to this testimony contains an in-depth analysis of this issue.

The FDIC certainly has had experience where the placement of an activity in a holding company affiliate has raised the cost of a resolution. For example, in many instances in the 1980s and early 1990s, data processing activities were conducted in a holding company affiliate. This gave the holding company bankruptcy trustee considerable leverage to extract fees from the bank receivership that the holding company would not have received had the data processing activities been conducted in the bank.

From a public-policy perspective, however, not all decisions should be dictated by savings to the deposit insurance fund at the time of bank failure. For example, there may be legitimate business reasons to place a data processing unit that is serving a number of different sister companies in a separate holding company affiliate. Similarly, it may be cheaper for a holding company to raise capital – thus benefiting insured banks – if nonbank activities are placed in holding company affiliates, rather than in bank subsidiaries where the entire net worth of the subsidiaries would be subordinated to depositors and the insurance fund. Thus, despite the

fact that the bank subsidiary mode of organization provides certain advantages at the time of bank failure, we believe it is important that banks have a choice of organizational structure.

In addition to safety-and-soundness issues, some have argued that banks have a lower net marginal cost of funds than nonbanks because of a perceived federal subsidy from deposit insurance and access to the payments system and the Federal Reserve discount window. Further, it is argued that the ability of institutions to pass a net subsidy from the federal safety net is easier under a bank subsidiary structure than under the holding company structure. Thus, the argument continues, activities conducted in bank subsidiaries are subsidized, resulting in an expansion of the federal safety net. For well-capitalized banks, the evidence shows that if a net marginal funding advantage exists at all, it is very small.

Setting aside the issue of whether a marginal safety-net subsidy exists and its magnitude, it is useful to consider the channels through which banks may have an opportunity to transfer a subsidy beyond the parent bank. First, banks could transfer the subsidy through capital infusions to their direct subsidiary, or by routing dividends through their holding company to an affiliate. Second, banks could extend loans or engage in the purchase or sale of assets at terms that favor their subsidiary units. Yet, in practice, regulatory safeguards for operating subsidiaries, such as those discussed above, and existing safeguards for affiliates, such as Sections 23A and 23B of the Federal Reserve Act, would inhibit a bank from passing any net marginal subsidy either to a direct subsidiary or to an affiliate of the holding company.

We also would note that forcing banks to conduct insurance and securities activities through holding company affiliates might be particularly burdensome to small banks that may not have holding companies. These banks would be required to set up a holding company structure in order to conduct new activities, or in some cases to continue to conduct existing activities. With increased competition in the banking industry, we need to be especially cautious about putting unnecessary regulatory burdens and costs on community banks.

Banking and Commerce

The financial modernization debate also encompasses the issue of whether banking organizations should be allowed to affiliate with commercial enterprises. Both the benefits and risks of mixing banking and commerce have been debated for many years. While there is no hard evidence that combinations of banking and commerce are harmful, there is no hard evidence that they are beneficial, either. Nevertheless, foreign and domestic marketplace developments suggest that combinations involving banking and commerce are becoming more numerous. Appendix B to this testimony discusses the mixing of banking and commerce in the United States in more detail.

H.R. 10 allows insurance companies, securities firms, and other firms that currently are not a bank holding company or a foreign bank that owned or controlled entities engaged in nonfinancial activities as of September 30, 1997, and became FHCs after enactment, to retain such ownership or control, subject to a "grandfather" provision that is limited in duration and volume of activities. An FHC could derive up to 15 percent of its annual gross revenues from

nonfinancial activities of its own, or of its subsidiaries other than depository institutions, and could not increase such activities through merger or consolidation. The grandfather provision would have a duration of ten years, with possible individual extensions of up to five years.

H.R. 10 grandfathers for perpetuity existing unitary savings-and-loan (S&L) holding companies and those companies that had filed an application to become a unitary S&L holding company as of October 7, 1998. A unitary S&L holding company controls only one savings association subsidiary, which must meet the Qualified Thrift Lender (QTL) test. Unitary S&L holding companies may engage, directly or through their non-thrift subsidiaries, in any activities that do not threaten the safety and soundness of their subsidiary savings association or do not have the effect of enabling a savings association to evade applicable laws or regulations. Beyond these general provisions, there are no limitations on the scope of permissible activities of unitary S&L holding companies. Thus, unitary S&L holding companies generally are permitted to engage in activities closely related to banking, general securities underwriting and dealing, other financial services, real-estate investment and development, and commercial and industrial enterprises.

Under H.R. 10, new unitary S&L holding companies, whose applications were filed after October 7, 1998, could engage in all activities classified as financial in nature, but not in nonfinancial activities. This provision of the bill would place limits on a vehicle that has enhanced financial modernization without causing significant safety-and-soundness problems. Commercial companies historically have not been a source of risk to the thrift industry. For example, in 1995, the Office of Thrift Supervision reported to the Congress that unitary S&L

holding companies, rather than causing harm to their subsidiaries, had in fact provided a source of strength to them in times of need. Moreover, the difference in the grandfather provision would create another class of institution that has no basis other than historical accident. Creating differences between otherwise identical institutions on the basis of arbitrary dates does not make economic sense.

Placing activity restrictions on unitary S&L holding companies would ignore recent developments concerning banking and commerce in the global financial marketplace. One such development is the 1998 merger of Daimler-Benz, Germany's biggest industrial group, with Chrysler Corporation to form DaimlerChrysler. Germany's Deutsche Bank owns slightly more than one-fifth of the stock of the former Daimler-Benz and was active in the merger discussions. Soon after the merger was consummated, DaimlerChrysler announced it would combine its global services operations, such as automobile leasing and finance, information technology, real estate, and telecommunications, into one financial services provider called DaimlerChrysler Services AG. According to news reports, this entity, which will be headquartered in Berlin, will be the fourth-largest provider of financial services in the world outside the banking and insurance sectors.

The emergence of domestic and foreign financial powerhouses, such as General Electric's GE Capital Services (see Appendix B) and DaimlerChrysler Services AG, underscores the need for policymakers to fashion and adopt a more realistic approach to the mixing of banking and commerce in the United States. The mixing of banking and commerce under H.R. 10 would be confined to grandfathered entities, as discussed earlier. In practice, this restriction

would preclude commercial banks and thrifts from affiliating with commercial enterprises and, in effect, would place a moratorium on the further mixing of banking and commerce in the United States at the federal level. This moratorium would not apply to domestic entities such as captive finance companies or industrial loan companies.

The FDIC supports a cautious easing of the restrictions on the mixing of banking and commerce, consistent with safety-and-soundness considerations. There have been no significant safety-and-soundness problems that have come to light in recent years regarding the mixing of banking and commerce. The provisions of the bill would place U.S. financial organizations at a competitive disadvantage in the global marketplace. Nevertheless, we recognize that U.S. banking organizations have had limited experience in affiliating with commercial enterprises. We believe that commercial activities should be permitted, provided that adequate safeguards exist to ensure safety and soundness. Moreover, we believe that we should proceed cautiously in order to allow banks time to adjust to a new competitive environment and to allow regulators and others to assess the actual benefits and risks of permitting banking and commerce to mix.

Regulatory Authority

Under Section 10(b)(4) of the Federal Deposit Insurance Act, the FDIC has the authority to examine any affiliate of any depository institution as may be necessary to disclose fully: (1) the relationship between such depository institution and any such affiliate; and (2) the effect of any such relationship on the depository institution. The FDIC has used this authority sparingly and only after careful analysis. The very fact the authority exists, however, gives the FDIC the

leverage to obtain necessary information that might not otherwise be available or forthcoming. The experiences of the 1980s underscore the importance of the insurer's ability to monitor in a timely and effective manner the relationships a depository institution has with its affiliates, especially during a period of major changes in the marketplace and the law. The current version of H.R. 10 preserves the FDIC's authority to examine any registered investment company for insurance purposes to determine the condition of an affiliated insured depository institution. Preservation of this authority is vitally important to allow the FDIC to discharge its insurance responsibilities and we commend you for including it in this bill.

The FDIC has a concern about the provisions in H.R. 10 that involve possible impediments to the evolution of products and services in the banking industry. H.R. 10 would narrow exemptions that banks have from registering as brokers or dealers under the securities laws. If doubt existed about whether an activity fell within an exemption, the Securities and Exchange Commission (SEC) would make the final regulatory determination and could use its enforcement authority to require registration. Thus, the SEC would have discretion to determine whether a bank needed to register as a broker or dealer and be subject to the regulatory requirements resulting from that status. Moreover, although one of the categories for exemption is effecting transactions in traditional banking products, the bill would authorize the SEC, after consultation with the Federal Reserve Board, to determine whether "new products" were securities, and thus subject to SEC regulation. Consequently, a nonbanking regulator would be given considerable authority over the activities of banks, a situation that could inhibit the evolution of banking products and services.

The last item regarding regulatory authority that concerns the FDIC involves certain potential disputes between federal banking regulators and state insurance regulators. For these disputes, H.R. 10 would eliminate the deference usually accorded federal agencies' interpretations of their statutes. We question whether this curtailment of the ability of federal banking regulators to determine the scope of the permissible products and services of banks is necessary or desirable. The concept of judicial deference recognizes an agency's expertise in interpreting any vagueness in federal legislation for which the agency has overall responsibility. We do not believe it is wise to begin a process that could erode the sound public-policy reasons for providing deference. Concerning the particular focus of these provisions of the bill, the elimination of the deference usually accorded the decisions of the federal banking regulators could, over time, produce a number of state-by-state differences in the treatment of the insurance-related activities of banks. Maintaining a degree of national uniformity in the area of the financial arena where insurance and banking meet would appear to be the preferable course.

Concluding Remarks

We have a unique opportunity to achieve financial modernization against the backdrop of a prosperous economy. This favorable environment will better enable institutions to accommodate the necessary changes. Rather than miss this opportunity, we should use it to its best advantage. Mr. Chairman and members of the Committee, the FDIC stands ready to work with you in this important endeavor.

APPENDIX A
Holding Company Affiliates and Operating Subsidiaries: Safety-and-Soundness Considerations

In considering financial modernization, two alternative organizational structures have been proposed. One would require that new activities such as securities or insurance underwriting be placed in a holding company affiliate. In order to own such an affiliate, the holding company would have to be well-capitalized. The other alternative would give banks the option of housing new activities in a bank operating subsidiary. This operating subsidiary would be subject to certain safeguards, including: application of the principles of Sections 23A and 23B of the Federal Reserve Act to transactions between a bank and its operating subsidiary; the requirement that the bank be well-capitalized; and the requirement that the bank's investment in the operating subsidiary be deducted from regulatory capital.

Safety-and-soundness issues arise in two situations: when the bank is healthy and the affiliate/subsidiary is financially troubled; and conversely, when the affiliate/subsidiary is healthy and the bank is financially troubled. Each is discussed below. We conclude that the affiliate and operating subsidiary structures offer similar protections when the bank is healthy and the affiliate or subsidiary is troubled, but that the operating subsidiary structure provides superior protection when the affiliate/subsidiary is healthy and it is the bank that is in financial trouble.

Bank Healthy – Affiliate/Subsidiary Troubled

There are a number of safety-and-soundness concerns that arise when a bank is financially strong but its affiliate or subsidiary is financially troubled. First, the bank might transfer funds to the subsidiary in an attempt to save its (or its parent's) investment. However, both the affiliate structure and the operating subsidiary structure provide the same limits on such exposure. In particular, the application of the principles of Sections 23A and 23B of the Federal Reserve Act to operating subsidiaries ensures that any extension of credit by a bank to its operating subsidiary would have the same limitations and safeguards as would apply to extensions of credit by the bank to its holding company affiliate. With respect to equity contributions, the bank might downstream capital to its subsidiary or it could upstream funds to its parent, which could then downstream the funds to the troubled affiliate. However, since the bank's investment in an operating subsidiary is deducted from regulatory capital and the bank would have to be well-capitalized under both the affiliate and operating subsidiary structures, equity transfers are limited to capital in excess of the well-capitalized threshold.

Of course, a bank might risk sanctions and illegally transfer funds to its affiliate or subsidiary in violation of Sections 23A and 23B, even though it would fall below the well-capitalized level. Such a transfer also might go undetected by regulators until it was too late. But, it is important to remember that banking organizations seek to maximize the return to their shareholders; thus, they have the same economic incentive to improperly transfer funds to an affiliate as to a subsidiary. In order for bank regulators to be able to detect improper capital transfers, bank regulators must have similar access to operating subsidiaries and holding

company affiliates, and similar mechanisms could be used to monitor capital flows between a bank and its operating subsidiaries and between a bank and its parent or affiliates. In short, banks may occasionally break the rules, and for a short time go undetected, but neither their incentive nor their ability to do so is affected by organizational structure.

Another safety-and-soundness concern arises when an affiliate/subsidiary fails. Despite limited liability, theoretically, the corporate veil may be pierced to make the bank accountable for the liabilities of its affiliate or subsidiary. First, it is important to note that piercing of the corporate veil is very rare. Second, corporate veils can be pierced between a parent and a subsidiary and between affiliates. The critical issue is not organizational structure, but whether the bank controls and dominates its affiliate or subsidiary so that they are held out to the public or operated as integrated entities. Under both the affiliate and operating subsidiary structures, there are certain straightforward steps a bank would be required to take to ensure that its affiliate or subsidiary is in fact separate from the bank. These steps include having separate management and record keeping for the two corporations, and not having identical boards of directors. With some basic safeguards such as these, the legal separation of both subsidiaries and affiliates can be reasonably ensured.

A third safety-and-soundness concern that could arise from a troubled affiliate or subsidiary is contagion, or reputational risk. That is, despite the fact that the bank may be legally insulated from the financial troubles of its affiliate or subsidiary, the troubles of the affiliates/subsidiaries may extend to the bank because they could undermine public confidence in the organization as a whole. This risk is real, but it depends largely on public perception, not

organizational structure. If regulators strictly enforce firewalls, there will be less contagion risk. If, on the other hand, regulators encourage banks to bail out troubled nonbank subsidiaries or affiliates, then contagion risk will be a larger problem for operating subsidiaries and affiliates alike.

Bank Troubled – Affiliate/Subsidiary Healthy

Safety-and-soundness considerations also arise when the affiliate/subsidiary is healthy and the bank is financially troubled. As noted earlier, banking organizations seek to maximize the return to shareholders. Thus, if a bank is in danger of failing, banking organizations have an incentive to shift resources from the bank to healthy nonbank affiliates. Since operating subsidiaries are an asset of the bank, no such incentive exists to shift resources out of a troubled bank into a healthy operating subsidiary. Of course, firewalls exist to protect the bank from an improper transfer of funds when a bank is near failure, and regulators monitor troubled banks very closely. Nonetheless, in the case of a troubled bank, there is less reason to be concerned with breaches in the firewalls between a bank and its subsidiary than between a bank and its affiliate.

A second safety-and-soundness consideration involves the support that the healthy affiliate or subsidiary gives to the bank, and hence, indirectly depositors and the insurance fund. Since, as noted above, an operating subsidiary is an asset of the bank, the earnings from or the proceeds of the sale of a subsidiary belong to the bank, and if a bank poses supervisory concerns, regulators can prevent those funds from being directed up to the holding company. In some

cases such funds might prevent a bank from failing. If the bank does fail, earnings or sale proceeds before failure will lower the insurance losses of the FDIC. If the subsidiary has not been sold before failure, then the subsidiary becomes an asset of the receivership and directly serves to limit the losses of the insurance fund.

The Federal Reserve's "source-of-strength" doctrine provides some of the same support for banks from bank affiliates, but not as completely and not as well as outright ownership. First, the source-of-strength doctrine has never been fully litigated, and bank holding companies have occasionally successfully balked at meeting the Federal Reserve's demand for capital injections into their insured banks. Second, even when bank holding companies have injected capital into banks that subsequently failed, the FDIC has twice been sued to recover some of those funds. In the First Republic failure, the recovery of funds downstreamed to the bank was one of several issues in a suit eventually settled out of court. A suit by the Bank of New England Corporation trustee in bankruptcy to recover funds and assets downstreamed by the holding company into the bank before failure was settled on January 6, 1999, with the payment of $140 million by the FDIC, as receiver and in its corporate capacity, to the bankruptcy estate. Finally, despite the source-of-strength doctrine, once a bank fails, the depositors and the FDIC have no claim whatsoever on the nonbank assets of the holding company. This differs markedly from an operating subsidiary, which, as noted earlier, would become an asset of the receivership and whose full value would accrue to depositors and the FDIC.

Conclusion

The operating subsidiary structure and the holding company structure provide similar safety-and-soundness protection when the bank is sound and the affiliate/subsidiary is financially troubled. However, when it is the bank that is financially troubled but the affiliate/subsidiary is sound, the operating subsidiary structure has a definite safety-and-soundness advantage.

APPENDIX B

The Mixing of Banking and Commerce in the United States

When criteria for permissible activities for the bank, its direct subsidiaries or its affiliates are discussed, the broader issue of whether, or to what extent, banking and commerce should be allowed to mix often arises. To a degree but by no means completely, banking and commerce in United States economic history have been conducted separately, with "separately" meaning conducted by organizations whose activities were, or are, limited to either the banking or commercial field with no formal, legal affiliations outside that field. This partial separation of banking and commerce seems to have been largely voluntary and unplanned, a response to the then-existing demands of the marketplace, level of technology, and state of development of organizational and business structure. In recent decades, however, much of the separation has been mandated by government.

Lines of separation can be drawn on two levels, prohibiting the mixing of banking and commerce within a single entity and prohibiting the common ownership of banking and commercial firms. Restrictions on permissible activities generally have existed in some form throughout American banking history. Restrictions on common ownership of banking and commercial firms are more recent, stemming from the Bank Holding Company Act of 1956 and its subsequent amendments.

The remainder of this Appendix discusses the mixing of banking and commerce in the United States, dating from the granting of early bank charters to the current environment. Following a brief discussion of the historical evidence on the mixing of banking and commerce, contemporary examples are reviewed. These examples include: grandfathered bank holding companies; savings-and-loan holding companies; nonbank banks; limited-purpose consumer banks; captive finance companies; industrial loan companies; and foreign activities of U.S. banking organizations.

Historical Background

Evidence on a government-mandated separation of banking and commerce within a single entity is mixed. Many early American bank charters included prohibitions against engaging in manufacturing or speculative real-estate activities. An absolute prohibition on banks engaging in "commercial" activities does not appear to have existed, however. In fact, in earlier times both private and chartered banks engaged directly in commerce.

The practice of combining banking and commercial activities was common during the period that ran approximately from 1799 to 1838. Bank charters were granted by state legislatures and provided a general right to incorporate and engage in banking, although they generally did not articulate what was meant by the business of banking. The mixing of banking with some form of commerce often occurred. During this period, economic development was characterized by a rapid expansion of business and the concurrent need for credit. Corporations that were chartered to engage in some particular line of commerce, for example, agricultural,

industrial or public-works interests, often also were given the authority to engage in a general banking business.

For example, the precursor to the Chase Manhattan Bank was chartered by the State of New York as the Bank of the Manhattan Company in 1799. The charter authorized the company to develop a water system for New York City and permitted the directors of the water company to use surplus capital in any way they saw fit, including the business of banking. The company subsequently engaged in the businesses of banking and life insurance and operated the water business throughout the nineteenth century.

As the states began to grant bank charters more freely, they also began to limit the nature of the banking business authorized by the charter. Early definitions of the "business of banking" reflected a recognition by the states that banks played an active role in the functioning of the economy and in serving business, but that some limits were necessary. Limits ultimately were included in the National Bank Act of 1864, which enumerated the powers granted to national banks as those that were "incidental to the business of banking." These limits did not pertain to affiliations.

During the last quarter of the nineteenth century and the first decades of the twentieth century, banks utilized a variety of corporate structures to affiliate with commercial enterprises, including voting trusts, the use of bank affiliates, and the establishment of bank holding companies. The best known voting trust involved linkages between J.P. Morgan and Company and a large number of commercial enterprises. Bank affiliates, in turn, had virtually unlimited

authority to engage in activities that were prohibited to banks. Affiliates were chartered under the general business corporation laws of the states, and were owned and controlled by the stockholders of the banks. Bank affiliates were not subject to any examination. Further incentive to use affiliates came, in part, from state and national branching restrictions that had limited the ability of commercial banks to provide large-scale financing to industry.

The bank holding company – a corporate entity that owns or controls a bank – became an alternative corporate structure in the early 1900s as the states began to allow corporations to purchase the stock of another corporation. In the last half of the 1920s, the bank holding company became an increasingly popular form of corporate structure in which banking and commerce were allowed to mix. Bank holding companies held controlling interest in commercial banks and other financial institutions as well as business corporations. Unless the holding company also was a bank, the holding company was subject to little federal or state control.

An important example of the use of the holding company structure during this period was the Transamerica Corporation. At its peak, the Transamerica Corporation held 100 percent ownership of many different holding companies. In 1930, these included holding companies for: bank stocks; stocks of securities corporations; general investments of stock-exchange securities; foreign holdings and investments; permanent commercial and industrial investments; stocks of joint-stock land banks; stocks of insurance companies; and stocks of mortgage companies. The holding companies, in turn, held both financial and commercial subsidiaries, including the Bank of Italy, the Bank of America, N.A., the Bank of America of California, Occidental Life

Insurance Company, Pacific National Fire Insurance Company, and Consolidated Foundries. The holding company structure clearly allowed Transamerica to engage in a wide variety of activities, effectively mixing banking and commerce. Enactment of the Bank Holding Company Act of 1956, however, required Transamerica to restructure its operations substantially.

Restrictions on the Mixing of Banking and Commerce

The Bank Holding Company Act of 1956. The rapid growth of bank holding companies caused concern among federal banking regulators about the potential for concentration of credit in the banking industry. Harsh controls were forestalled in part by the Congress' concern about the extent to which it could legally exercise control over state-chartered corporations, especially in the face of evidence that bank holding companies played a positive role in the banking industry. But the concern eventually was overridden by the continued expansion of bank holding companies and the fear of monopolistic control in the banking industry.

The Banking Act of 1933 first defined bank holding companies and established the framework for their regulation. However, the restrictions on ownership and affiliation as they are known today are the product of the Bank Holding Company Act of 1956 and its subsequent 1966 and 1970 Amendments. The basis for the expansion of bank holding company regulations was the belief that it was necessary to prevent the monopolization of banking by holding companies and the formation of large banking-industrial complexes. With the passage of the 1970 Amendments, virtually all bank holding companies became subject to federal regulation,

and statutory and regulatory controls were placed on the expansion of bank holding companies into other businesses. That is, a separation of banking from commerce was established in terms of restrictions on the activities of the owners and affiliates of banks.

Under the Bank Holding Company Act (BHCA) of 1956, a bank holding company was defined as a corporation owning at least 25 percent interest in two or more commercial banks, whether Federal Reserve members or not. Federal Reserve Board approval was required for the creation or expansion of bank holding companies; interstate acquisitions of banks were limited, and the right of states to limit bank holding company expansion was upheld. Ownership of shares in nonbank corporations, other than those of corporations engaged in approved bank-related activities, were prohibited. The 1956 Act also prohibited a bank holding company or its nonbank subsidiary from engaging in any nonbanking activity, except as otherwise provided in the BHCA. Bank holding companies were allowed to engage in certain activities. The Federal Reserve Board was given the authority to allow additional nonbanking activities other than those expressly permitted if they could be shown to be "of a financial, fiduciary, or insurance nature" and were "so closely related to the business of banking or managing or controlling banks as to be a proper incident thereto."

Bank Holding Company Act Amendments. The BHCA was amended in 1966 and 1970. The 1966 Amendments primarily addressed problems in the 1956 Act. Standards for the evaluation of holding company applications were revised and exemptions from the BHCA provisions for investment companies and their affiliates, religious, charitable and educational institutions were eliminated. The 1966 Amendments also relaxed the 1956 Act by applying

Section 23A of the Federal Reserve Act to transactions between sister subsidiary banks; the 1956 Act had prohibited virtually all normal banking transactions between these entities.

The 1970 Amendments were focused on the regulation of one-bank holding companies and the nonbank activities of bank holding companies. The rapid growth in the number and size of one-bank holding companies during the 1960s raised concern among bank regulators and led to demands from the Congress and independent banks for the inclusion of one-bank holding companies under the BHCA. The 1970 Amendments accordingly extended regulation under the BHCA to one-bank holding companies. As a result, Federal Reserve Board oversight was extended to virtually all bank holding companies.

The 1970 Amendments also revised the standards that defined permissible nonbank activities. Under Section 4(c)(8), the Federal Reserve Board, through the use of regulation, interpretation, or individual decisions, has ruled on the permissibility of numerous nonbank activities. A bank holding company or its nonbank subsidiary may engage in a nonbanking activity, including a securities activity, only if the Federal Reserve Board determines that (1) the activity is "closely related to banking" and (2) the provision of the activity would likely result in public benefits that outweigh possible adverse effects. The Federal Reserve Board also was given authority to differentiate between applications to engage in an activity through a de novo subsidiary or acquisition of an existing firm. Anti-tying provisions that prohibit a banking company from tying an extension of credit or any other bank service to the use of the services of nonbank subsidiaries of the holding company were incorporated through Section 106 of the BHCA under the 1970 Amendments.

Most of the nonbanking activities that have been approved by the Federal Reserve Board for bank holding companies under Section 4(c)(8) also have been permitted for national banks as "incidental to banking" under the Office of the Comptroller of the Currency's Interpretive Letters. Over the past few years the Federal Reserve Board has issued a large number of Section 4(c)(8) decisions, most of which relate to investment and merchant banking activities. As a result, the original intent of Glass-Steagall to separate commercial from investment banking has been blunted.

Banking and Commerce in the Financial Services Industry

Grandfathered Bank Holding Companies. As a result of the 1970 Amendments to the BHCA, a number of commercial firms that owned banks found that they would subsequently be regarded as bank holding companies. The 1970 Amendments, however, provided exemptions for these companies if they met certain criteria. Ultimately, the Federal Reserve Board granted hardship exemptions to 12 companies. Although most of the banks have since been sold to other banks, a few continue to be owned by commercial firms.

Savings-and-Loan Holding Companies. Corporate owners of thrifts are savings-and-loan holding companies. In 1967, the Congress placed restrictions on the activities of multiple savings-and-loan holding companies, effectively prohibiting them from engaging in commercial activities. No such restrictions were placed on the non-thrift activities of unitary savings-and-loan holding companies -- companies that owned a single savings-and-loan association. In 1987,

the Congress extended to some multiple savings-and-loan holding companies (those thrift subsidiaries that were acquired in qualifying supervisory transactions involving failed or failing institutions and were consummated under federal regulatory oversight) the benefit of unrestricted activities enjoyed by unitary savings-and-loan holding companies. The Congress, however, also imposed the requirement that to continue to be free from prohibitions on non-thrift activities, unitary and otherwise qualifying multiple savings-and-loan holding companies must have their thrift subsidiaries meet the qualified thrift lender (QTL) test.

Nonbank Banks. Before the enactment of the Competitive Equality Banking Act of 1987 (CEBA), the BHCA defined "bank" as an institution that both took demand deposits and made commercial loans. An organization that did one or the other, but not both, was not a bank under the BHCA. Such an organization with a bank charter came to be called a "nonbank bank," and in the early and mid-1980s the possibilities of nonbank banks attracted considerable attention. Bank holding companies saw nonbank banks as a way to expand across state lines and seek favorable usury limits without running afoul of the interstate banking restrictions of the BHCA. Commercial firms and nonbanking financial firms saw nonbank banks as an avenue into the banking business without running afoul of the nonbanking restrictions of the BHCA.

In CEBA, the Congress closed the so-called "nonbank bank loophole" by broadening the definition of "bank" in the BHCA to cover any institution that either met the then-existing definition or was insured by the FDIC. Both types of owners of nonbank banks received some grandfathering protection, however. For the type of owner that might mix banking and commerce – the owner that was not a bank holding company – grandfather rights would be lost if

the company otherwise became a bank holding company or if the nonbank bank did one or more of the following: (1) began to engage in activities in which it was not lawfully engaged on March 5, 1987; (2) offered or marketed products or services of affiliates that were not permitted for bank holding companies, or permitted its products or services to be offered or marketed by affiliates whose activities were broader than those permitted for bank holding companies; (3) permitted any overdraft on behalf of an affiliate or incurred any overdraft in its account at a Federal Reserve Bank on behalf of an affiliate; or (4) increased its assets by more than 7 percent in any one 12-month period. The fourth restriction was repealed by Section 2304 of the Economic Growth and Paperwork Reduction Act of 1996.

Limited-Purpose Consumer Banks. The Comptroller of the Currency is authorized to grant national bank charters that operate under certain restrictions, such as a prohibition on commercial lending. Numerous large retail companies have acquired such charters to provide credit for their customers. The owners of these banks do not fall under the Bank Holding Company Act. Several states also charter such limited-purpose banks.

Captive Finance Companies. Finance companies compete with banks in extending credit to businesses and consumers, in some instances making the same types of loans. And although finance companies do not take deposits from the general public, their funding is in many respects similar to bank funding. Both rely to a considerable degree on what might be called purchased funds: bonds and commercial paper for finance companies, and large-denomination certificates of deposit for banks.

Where finance companies provide an approximation of the mixing of banking and commerce is in the so-called captive finance companies. These institutions are owned by commercial firms, usually manufacturing and distribution firms. Captive finance companies originated from efforts by manufacturers to promote sales of their products by offering convenient access to credit. Some captives have expanded beyond these beginnings, however, to lend to other businesses and to perform such investment banking functions as financing mergers and participating in leverage buyouts. General Electric's GE Capital is the primary example of a captive that pursued new opportunities beyond its parent's business.

The experience of captive finance companies might have some relevancy to the banking and commerce debate. Although their primary purpose might be to promote the sales of their parents' products, captive finance companies appear generally to have been operated as profit centers. They do not appear to have been used to inflate sales by exploiting access to underpriced funds. One fear about mixing banking and commerce is that the banking side of the organization would be used to subsidize in some fashion the commerce side. Such a subsidization does not appear to have occurred with captive finance companies. For example, the expansion of GE Capital Services to activities beyond the financing of sales of its parent's products demonstrates the power of the profit motive and suggests that attempting to operate a captive without regard to its profitability might be difficult.

Industrial Loan Companies. Also known as industrial banks, industrial loan companies are state-chartered entities that have broad banking powers, subject to certain lending and deposit restrictions. Industrial loan companies may be owned by commercial firms without falling under

the BHCA. Under the Garn-St Germain Depository Institutions Act of 1982, industrial loan companies that are regulated in a manner similar to commercial banks can apply for federal deposit insurance. Located primarily in the Midwest and West, the owners of these institutions include finance companies, oil companies, and securities companies. Industrial loan companies also often are owned by companies that operate credit-card banks in other states. In 1997, Utah lifted a ten-year moratorium on the issuance of new industrial loan company charters. Advantages of the Utah charter include the ability to make commercial loans, and the ability to "export" their interest rates beyond their state boundaries regardless of interest-rate caps elsewhere. There are no restrictions on ownership in the Utah industrial loan company charter.

Foreign Activities. Under Subpart A of the Federal Reserve Board's Regulation K, U.S. banking organizations can invest in a somewhat wider range of activities outside the United States than within. The foreign activities of Federal Reserve member banks, Edge Act corporations, and bank holding companies – the vast majority of the components of the U.S. banking industry that conduct foreign activities – are covered by Subpart A.

Generally, foreign activities must be of a banking or financial nature, although the list of permissible activities in Regulation K is broader than the list in Regulation Y of permissible domestic activities for bank holding companies. Among the activities in Regulation K are: general insurance agency and brokerage; underwriting life, annuity, pension fund-related, and other types of actuarially-predictable insurance; operating a travel agency provided the agency is

operated in connection with financial services; and subject to certain limits, underwriting, distributing, and dealing in equity securities.

Regulation K also permits some degree of investment in activities beyond those of a banking or financial nature. The Regulation recognizes three categories of ownership, control, or investment by a U.S. banking organization: (1) subsidiary – ownership or control of more than 50 percent of the voting shares; (2) joint venture – ownership or control of 20 to 50 percent of the voting shares; and (3) portfolio investment – ownership or control of less than 20 percent of the voting shares. In a subsidiary acquired as a going concern, existing activities that are not otherwise permissible may account for not more than 5 percent of either consolidated assets or revenues of the acquired organization. For a joint venture, not more than 10 percent of consolidated assets or revenues may be attributed to activities not on the list of permissible activities. Portfolio investments in organizations engaged in activities not permissible may not exceed: (1) 40 percent of the total equity of the invested-in organization; or (2) 25 percent of the investor's Tier 1 capital if the investor is a bank holding company or 100 percent of Tier 1 capital for any other investor.

FEDERAL DEPOSIT INSURANCE CORPORATION, Washington, DC 20429

OFFICE OF THE CHAIRMAN

March 8, 1999

Honorable James A. Leach
Chairman
Committee on Banking and Financial Services
House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

I am pleased to respond to a question submitted by Congresswoman Sue Kelly subsequent to my February 12 testimony before the Committee. In order to gauge the Federal Deposit Insurance Corporation's support for or opposition to the mixing of banking and commerce, the Congresswoman asked whether the FDIC would "favor a basket approach or for H.R. 10 to remain as it is now without a mixing of banking and commerce."

An important question raised by the financial modernization debate is whether banking organizations should be allowed to affiliate with commercial enterprises. As I discussed in my written testimony on H.R. 10, the Financial Services Act of 1999, the current provisions of the bill would place U.S. financial organizations at a competitive disadvantage. Any mixing of banking and commerce under the bill would be confined to grandfathered entities, and commercial banks and thrifts would be precluded from affiliating with commercial enterprises.

The FDIC believes that banking organizations should be allowed to engage in commercial activities, provided that adequate safeguards exist to ensure safety and soundness. It is vitally important, for example, that the depository institution subsidiaries of a bank holding company wishing to engage in commercial activities should be well-capitalized and well-managed. Moreover, we should proceed cautiously in order to allow banks time to adjust to a new competitive environment and to allow regulators and others to assess the actual benefits and risks of permitting banking and commerce to mix.

To that end, the FDIC supports a basket approach to the mixing of banking and commerce. In general, the FDIC favors an immediate five percent commercial basket. An analysis done by FDIC staff in 1997 showed that of 28 large brokerage, insurance, and diversified financial services firms, 21 received at least 95 percent of their revenues from financial services. Thus, a five percent basket would go a long way toward establishing a two-way street, and unlike grandfathering, a five percent basket would not favor those who already have commercial activity over those who do not. If problems do not occur as a result of a five percent basket, the percentage could be increased in the future.

In summary, the FDIC supports a cautious easing of the restrictions on the mixing of banking and commerce, consistent with safety-and-soundness considerations, and would like to see H.R. 10 modified to incorporate a basket approach to the mixing of banking and commerce.

Your interest in this matter is appreciated. If you have further questions, Alice Goodman, Director, Office of Legislative Affairs can be reached at 898-8730.

Sincerely,

Donna Tanoue

Donna Tanoue
Chairman

cc: Honorable Sue Kelly

For Release Upon Delivery
February 12, 1999, 10:00 a.m.

TESTIMONY OF JOHN D. HAWKE, JR.

COMPTROLLER OF THE CURRENCY

Before the

COMMITTEE ON BANKING AND FINANCIAL SERVICES

of the

U.S. HOUSE OF REPRESENTATIVES

February 12, 1999

Statement required by 12 U.S.C. § 250:

The views expressed herein are those of the Office of the Comptroller of the Currency and do not necessarily represent the views of the President.

Introduction

Mr. Chairman, thank you for the opportunity to appear before you today to discuss H.R. 10, the "Financial Services Act of 1999." Virtually everyone agrees that the laws that currently prohibit affiliations among banks and other financial services providers and limit the ability of banking organizations to diversify their financial activities are archaic. Changing these laws in ways that promote increased competition, greater efficiency, and more effective delivery of financial products to consumers will strengthen U.S. financial services firms and benefit their customers.

Financial modernization is both a political process and the process of innovation in a competitive marketplace. Every day, financial services firms evolve and adapt to serve the changing needs of their customers. Technological advances and the development of new financial products and services have increasingly blurred the old lines that once separated the offerings of banks, securities firms, and insurance companies. As a result, consumers of financial services now have a greater choice of financial services and products, at more competitive prices.

An important goal of financial modernization legislation should be to ensure that the government does not impede or frustrate the process taking place in the marketplace. Of course, some constraints are necessary to ensure that the interests of consumers are properly protected, and that important governmental interests are safeguarded. But legislation that is crafted to preserve competitive advantages for particular interests, to discriminate against any segment of the industry, or to limit the choices financial firms have for organizing their businesses for no compelling or clearly demonstrable public policy purpose, retards the real and dynamic financial modernization already occurring in the marketplace. Even more significantly, legislation that will diminish the safety and soundness of our insured financial institutions should not be enacted under the guise of "financial modernization." I am greatly concerned that some aspects of H.R. 10 may have this effect.

In my testimony today, I will discuss why I believe that financial modernization legislation should be pursued in a form that will not interfere with the free operation of financial markets, except to the degree necessary to protect fundamental and clearly demonstrable government interests, such as promoting the safety and soundness of our financial system and safeguarding the interests of consumers. I will then broadly address the provisions of H.R. 10 that relate to bank organizational structure, insurance activities, and consumer protection issues. I am attaching to my testimony a more detailed analysis of the bill's provisions and the Office of the Comptroller of the Currency's (OCC) views on the major issues it presents. My testimony will highlight some areas we support and those that concern us.

Modernization Has Been Occurring in Financial Markets

Federal laws restricting bank geographic and product diversification date back nearly 70 years. Although many restrictions have been removed, allowing banks to become more efficient and competitive, significant constraints still exist. Geographic restrictions on bank

location were dramatically reduced when the Riegle-Neal Interstate Banking and Branching Efficiency Act was passed in 1994. However, other laws restricting the activities of banking organizations remain, most notably, the Glass-Steagall Act of 1933, which was intended to separate commercial banking from investment banking, and provisions of the Bank Holding Company Act that confine the ability of corporations owning banks to diversify into other financial activities.

It has become clear in recent years that these constraints segregating various sectors of the financial marketplace have outlived their usefulness. The financial services marketplace has undergone enormous changes. Banks, securities firms, and insurance companies increasingly offer a similar array of products and services. Regulatory and judicial rulings continue to erode many of the barriers separating the different segments of the financial services industry. In short, technological and financial innovation, together with market pressures to offer consumers a wider array of services, are breaking down the traditional segmentation of the financial services marketplace.

While many financial service providers have been able to respond to these competitive forces without legislation, there is a strong case that the time has come for Congress to unambiguously undo antiquated constraints that exist in current law and bring the statutory framework into line with the realities and needs of the marketplace. I respectfully regret to say, however, that many of the provisions in the current version of H.R. 10 impose new and needless constraints on banks, particularly our nation's community banks, and will not permit them to innovate and compete in the most efficient manner. Those provisions will have significant adverse effects on the long-term safety and soundness of our banking system.

Ability to Diversify Products and Services is Essential to Banks' Safety and Soundness

Preservation of the safety and soundness of the banking system is a fundamental government interest and a pivotal consideration in any financial modernization legislation. For this reason, we have supported the inclusion of strong safety and soundness provisions, such as the requirement that all of the banks in a holding company be well capitalized and well managed, as a precondition for engaging in expanded activities. But protecting the safety and soundness of banking institutions involves more than simply writing safeguards against loss into the law. Providing banks the opportunity to maintain strong and diversified earnings through a range of prudently conducted financial activities is an equally critical component of safety and soundness.

Historically, banks have been heavily dependent on net interest margins -- traditional lending -- as a source of earnings. This makes banks particularly vulnerable to changes in economic conditions. During the 1990s, the net interest income of commercial banks has declined, both as a percentage of assets and as a percentage of net operating revenue, and the growth in the volume of lending activity due to the strong economy has been offset by significant compression in bank net interest margins. At the same time, however, banks have been able to preserve or enhance their profitability through growth in noninterest income. In the last 10 years alone, noninterest income has increased from approximately 30 percent of net operating revenue to 39 percent. Noninterest income consists primarily of fees, service

charges, commissions, and the performance of data processing services for others, and is equally critical to large and small institutions trying to enhance and vary their income streams. Thus, banks' long-term stability and viability will be affected by whether they are allowed to continue to pursue financial activities that produce noninterest income to counterbalance the likely continued reduction in earnings from interest-bearing assets.

Banks can seek additional earnings sources by providing new products and services or moving into new geographic markets; or they can improve earnings by reducing their operating costs or increasing their risk profile in their lines of business. The OCC and other financial institution regulators have increasingly expressed concern about banks taking on additional credit risks to achieve high earnings targets, particularly given the slowdown in global economic activity and the likelihood of stresses in regional economies. Evidence over the past year showing deterioration in the quality of loan underwriting standards for commercial and industrial loans has been a particular source of worry.

Product, geographic, and income diversification all contribute importantly to bank safety and soundness. Many different factors have been responsible for the waves of bank failures that have characterized various periods of our financial history. However, one consistent factor has been excessive *concentrations* -- geographic concentrations or concentrations in one or another type of *lending.* The high rate of bank failures in the 1920s was largely confined to small agricultural banks that lacked diversification with respect to either geography or lines of business. In the early 1980s, banks that had excessive concentrations of loans in the oil business and/or in the southwestern region of the United States failed in large numbers. Many of the banks that failed in the years 1984-1986, when agricultural land prices fell more than 40 percent from their 1981 peak, also appear to have suffered from an inability to diversify. And, finally, in the late 1980s and early 1990s, bank failures throughout the world were associated with excessive real estate lending.

Ideally, of course, bank regulators could anticipate what geographic areas and product lines would be associated with future loan losses and would use their powers of persuasion to prevent banks from developing heavy exposures in lending to those areas. Given the impossibility of perfectly foreseeing the future regarding the nature and location of lending problems, however, the prudential strategy of diversification reduces the vulnerability of banks to unexpected losses from lending, wherever they may occur.

A wealth of empirical research demonstrates that diversification is critically important to maintaining a strong banking system. Firms with diversified assets and revenue streams can better withstand economic shocks during the business cycle, whereas firms limited by geographic or product restrictions can be impacted more seriously by downturns. Diversification can enable banks to increase their average rate of return for any given volatility of return, or to reduce the volatility of earnings for any average level of return, in either case reducing their probability of failure.[1]

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[1] For a review of the literature, see Mote, Larry, R., "The Separation of Banking and Commerce," *Emerging Challenges for the International Services Industry,* JAI Press, 1992, pp. 211-17, and Whalen, Gary, *Bank Organizational Form and the Risks of Expanded Activities,* Economics Working Paper 97-1, January 1997, pp.5-12.

The business of banking revolves around risk management, and banks have demonstrated they can effectively manage a variety of risks. Banks already manage complex risks, such as those associated with derivatives and other off-balance sheet activities -- risks that are similar to those presented by new financial activities, such as insurance. The effect of H.R. 10, which forces banks to remain primarily intermediaries of credit risk, is to make them inherently more exposed to risk than institutions with diversified sources of income. When bank activities are restricted, risk exposures are correspondingly concentrated, and the banking system as a whole is more vulnerable to economic shocks.

Operating Subsidiaries Will Strengthen Banks and Enhance Safety and Soundness

Financial modernization legislation should not artificially restrict the ability of financial services providers to choose, consistent with safety and soundness, the most efficient way to conduct their business. There is no a priori governmental interest in restricting organizational choice, and with appropriate safeguards, expanded activities may be conducted safely and soundly in either a bank subsidiary or a bank affiliate.

The current version of H.R. 10 mandates that banking organizations wishing to diversify into new activities as principal do so only through bank holding company affiliates -- a "one-size-fits-all" approach that needlessly denies firms the choice of expanding through a bank subsidiary structure. This restrictive approach undermines, rather than enhances, safety and soundness. It will inevitably force resources out of banks and diminish the protections for the federal deposit insurance fund.

Consider the business decision facing a banking organization that may want to take advantage of a newly legislated opportunity to expand into insurance or securities activities. If the only organizational choice available is the holding company affiliate, it is highly likely that resources of the bank will be drawn down to capitalize and fund the new activity. The bank will upstream dividends to its parent either to inject capital into the new affiliate, or to support new holding company debt or equity issued for that purpose. The bank itself will reap no financial benefit from the new activity. In fact, since many of the business opportunities of the new affiliate may be generated by the day-to-day business of the bank, the bank will be deprived of profit opportunities that would rightfully belong to and be captured by it if the operating subsidiary format had been permitted.

By contrast, if the new activity could be positioned in a subsidiary of the bank, any capital or funding provided by the bank would remain as part of the bank's consolidated resources. In addition, banks would be able to capture directly the benefits of new business opportunities that may be closely related to, or generated by, their normal day-to-day banking activities. Income flows resulting from such new activities would flow directly to the bank, would not be diverted to the holding company, and would provide the bank with a diversified source of earnings. And, as the Federal Deposit Insurance Corporation (FDIC) has repeatedly testified, in the event that a bank should itself suffer financial difficulties, earnings from bank subsidiaries can compensate for a downturn in bank profits, and, in the event of bank failure,

the existence of such subsidiaries can significantly reduce the losses of the federal deposit insurance fund.

There is also clear evidence that banking organizations can benefit from engaging in expanded financial activities through bank subsidiaries without creating undue safety and soundness concerns. For example, the Federal Reserve Board has long permitted U.S. banking organizations to engage in securities activities overseas through foreign subsidiaries. At year-end 1997, U.S. banking organizations operated 100 direct and indirect bank securities subsidiaries, a high proportion of which (88 percent) were profitable, with aggregate net income of $732.3 million.[2]

This comparison also highlights the discriminatory nature of the structural restraints H.R. 10 imposes on U.S. banks as compared to foreign banks. Under H.R. 10, U.S. banks could have subsidiaries -- operating abroad -- that conduct an expanded range of financial activities. But a *U.S.* bank's domestic subsidiary cannot engage in the activities that are permissible for that bank's foreign subsidiary. Also, a *foreign* bank may engage in nonbanking activities in the U.S., including securities underwriting, through a direct subsidiary of the bank. But a *U.S.* bank could not have a *U.S.* subsidiary that engages in the same range of activities permitted for a *foreign* bank's *U.S.* subsidiary. Thus, U.S. law would allow a foreign bank to use the structure it determines most efficient for the delivery of products and services in the United States, while U.S. banks would be restricted to a single format. This result cannot be rationalized.

In addition, H.R. 10 uniquely discriminates against national banks relative to *state* banks by retaining or imposing burdensome statutory requirements that are not imposed on state banks. For example, national bank subsidiaries are flatly barred from engaging as principal in expanded financial activities; state banks are subject to no such comprehensive bar. Further, although the bill requires that all of a national bank's depository institution affiliates be well capitalized and well managed in order for the national bank's subsidiary to conduct new *agency* activities, no similar requirements are imposed on either state banks or thrifts engaged in the same activities through subsidiaries. And national bank subsidiaries, in addition to being limited to expanded financial activities conducted on an *agency* basis, are further limited to conducting those new agency activities *only* through a *wholly-owned* subsidiary. Thus, national banks, but not state banks, are deprived of the ability to use joint ventures or consortiums of banks to engage in new agency activities. This type of outright discrimination in the treatment of national banks embedded in H.R. 10 is simply impossible to justify on any principled basis.

Moreover, the approach embodied in H.R. 10, which would force resources out of banks, is contrary to the interests of the federal deposit insurance fund. FDIC Chairman Donna

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[2] At year-end 1997, these 100 direct and indirect bank securities subsidiaries had aggregate total assets of $249.5 billion. They represented 90.9 percent of the total number of overseas securities subsidiaries and accounted for more than 98 percent of the total assets in all foreign securities subsidiaries. The average aggregate rate of return on assets for bank securities subsidiaries over the 1987-1997 period was around 60 basis points, roughly three times higher than the comparable figure for holding company securities subsidiaries. See Whalen, Gary, *The Securities Activities of the Foreign Subsidiaries of U.S. Banks: Evidence on Risks and Returns*, Economics Working Paper 98-2, February 1998.

Tanoue and former FDIC chairs have consistently pointed out that the subsidiary format provides better protection for the deposit insurance fund. Last September, in a joint article in the *American Banker*, former Chairmen Helfer, Isaac, and Seidman stated their position clearly: "Requiring that bank-related activities be conducted in holding company affiliates will place insured banks in the worst possible position. They will be exposed to the risk of the affiliates' failure without reaping the benefits of the affiliates' successes."[3] In her testimony before the Senate Banking Committee last June, Chairman Tanoue stated that "the subsidiary structure can provide superior safety and soundness protection."[4] In 1997, former Chairman Helfer noted in her testimony that "[w]ith appropriate safeguards, having earnings from new activities in bank subsidiaries lowers the probability of failure and thus provides greater protection for the insurance fund than having the earnings from new activities in bank holding company affiliates. The reason for this is that diversification often leads to less volatile earnings. ...Thus, on average, allowing a bank to put new activities in a bank subsidiary lowers the probability of failure and provides greater protection to the insurance funds."[5]

One could argue, then, that from the perspective of prudent bank supervision and the interests of the deposit insurance fund, the *only* format that should be used for expanded activities is the operating subsidiary. But individual banking organizations may have particular reasons, based on their business, why the use of a holding company affiliate is more effective for them, and a prescriptive approach would be inconsistent with the basic principle I discussed earlier -- that restrictions on organizational format should not be imposed except where unavoidably needed to protect clearly defined governmental interests. To forbid the operating subsidiary format, however, is not only flatly inconsistent with that principle, but positively inimical to well defined governmental interests. The responsible approach is to allow institutions the freedom to choose the organizational structure that best suits their needs, subject -- in either case -- to the imposition of solid financial protections for insured banks.

Promoting Full and Fair Competition in Insurance Markets Benefits Consumers

Financial modernization legislation should nurture innovation in the marketplace so that consumers have better access to a greater variety of financial products and services at more competitive prices. To that end, any new law should maximize business opportunities for all market participants by eliminating archaic or protectionist restraints on the delivery of products and services. In the insurance area, H.R. 10 does not achieve that result. Instead, it hobbles banks that want to sell insurance by undercutting the Supreme Court's decision in the *Barnett* case and sanctioning discriminatory state insurance sales laws.

The *Barnett* case applied well recognized judicial standards of preemption to states' efforts to curtail the "broad permission" that national banks have to sell insurance under the

[3] "Ex-FDIC Chiefs Unanimously Favor the Op-Sub Structure," *American Banker*, September 2, 1998.

[4] See testimony of Donna Tanoue, Chairman, FDIC, on financial modernization before the Committee on Banking, Housing, and Urban Affairs, United States Senate, June 25, 1998.

[5] See testimony of Ricki Helfer, Chairman, FDIC, on financial modernization before the Subcommittee on Capital Markets, Securities, and Government Sponsored Enterprises, Committee on Banking and Financial Services, U.S House of Representatives, March 5, 1997.

federal statute that authorizes national bank insurance sales. H.R. 10 would replace the law and precedents as they stand today with a virtually indecipherable combination of: 1) not one, but several new preemption standards to apply to different types of insurance activities; 2) "safe harbors" of unclear scope that allow the states to impose discriminatory restrictions on bank insurance activities free from *any* preemption by federal law; 3) new definitions and redefinitions of insurance products that will tell if a bank can even provide an insurance product *at all*; 4) a new standard for judicial review of issues that arise under these new standards; 5) *differences* in preemption standards applicable depending upon *when* a particular state's provision was adopted; and 6) the astonishing prospect that in each state, banks selling insurance could be subject to a different combination of some or all of the insurance sales customer protection regulations required to be promulgated by the federal banking agencies and state provisions that, in a given state would sometimes co-exist with, sometimes supercede, and sometimes would be superceded by, particular provisions of those federal rules.

For example, the bill lists 13 "safe harbor" areas in which the states may legislate or impose regulations or restrictions on banking organizations selling insurance that would not apply to nonbank competitors, and to do so free from any federal constraints. In these 13 areas -- which include important aspects of insurance sales such as licensing requirements, disclosures, and advertising -- *any* state may write rules for banks and companies affiliated with banks that are more onerous than those for any other insurance provider. Those state rules may be written (as some state rules have been) in ways that unreasonably disadvantage banks and bank affiliates relative to other insurance providers. Indeed, even if the purpose of such rules were to provide a competitive advantage to nonbank competitors -- which would almost certainly be their effect -- they would still be protected. Any state provision that fits within one of these "safe harbors" would be immune from challenge despite such discrimination, and even if, contrary to the *Barnett* standard, it prevented or significantly interfered with the authority of national banks to sell insurance.

The OCC does not seek to be an insurance regulator and supports the role of state insurance regulators in the supervision of insurance activities conducted by banks, their subsidiaries, and their affiliates. Since the *Barnett* decision was handed down, the OCC has tried to work constructively with state insurance regulators to resolve issues where state provisions impacted national banks in a manner contrary to the principles of the *Barnett* decision. In those very few cases where differences of opinion were litigated, the courts had clear and time-tested standards of preemption that they used to resolve the questions presented.

The tangle of insurance provisions in H.R. 10 is most likely to produce new rounds of litigation in several areas, under untested new standards. These provisions are not necessary to ensure that adequate customer protections exist for bank insurance sales and actually retard the development of new products and delivery channels that could benefit customers.

Moreover, it is clear that H.R. 10 does not modernize the ability of national banks in particular to participate in the insurance sales market, nor does it promote parity with their state-chartered competitors. The federal statute that the Supreme Court reviewed in *Barnett* authorizes national bank insurance sales only in places with 5,000 or fewer inhabitants. H.R.

10 leaves this restriction in place even though it is just as outdated as the Glass-Steagall provisions that the bill would repeal. Moreover, at least 17 states permit bank-direct insurance sales in state-chartered banks free from any similar geographic limitation.[6] After enactment of H.R. 10, then, national banks will continue to be subject to an outdated constraint on their ability to compete in insurance markets.

The insurance provisions in H.R. 10 perpetuate an approach to financial services legislation that attempts to segment markets and retain competitive advantages for favored groups. They retard, rather than encourage, competitive and marketplace developments and thus they fail the key test for financial modernization legislation.

Ensuring Adequate Consumer Protection is an Essential Component of Financial Modernization

Financial modernization legislation also must ensure that the interests of consumers are appropriately protected through adequate disclosure mechanisms and the deterrence of deceptive sales practices. The federal banking agencies have worked together to advise depository institutions to conduct retail sales in a safe and sound manner that protects the interests of consumers. It is not only appropriate but essential for the government to foster an environment in which consumers can evaluate the relative riskiness of their financial choices based on a fair understanding of the products and services available to them.[7] But to do this, the standards expected of banks need to be clear and workable. The scheme of insurance customer regulations that would be applied under H.R. 10 is neither.

Finally, it is important to note that technological advances and the emergence of diversified financial services companies have also raised significant issues regarding the proper handling and safeguarding of customer financial information and the protection of consumer privacy. The financial services industry has many years of experience in handling that information and protecting their privacy. As banks affiliate with other financial services providers, and share an increasing amount of confidential customer information, it is imperative that regulators have the ability to ensure compliance with existing privacy laws that govern the handling of customer information. It is for this reason that we urge that the bank regulators' examination authority under the Fair Credit Reporting Act be restored.

Conclusion

In conclusion, let me again emphasize the importance of limiting intervention in financial markets to that which is necessary to protect clearly defined, demonstrable

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[6] See Conference of State Bank Supervisors, *A Profile of State Chartered Banking*, (16th edition, 1996).

[7] The OCC's "Guidance to National Banks on Insurance and Annuity Sales Activities," issued on October 8, 1996 ("Advisory") instructs banks to follow proper procedures to ensure customers are able to distinguish between insurance and deposit products. These procedures include making adequate disclosures that an insurance product is not FDIC insured, is not a deposit or an obligation of the bank, and is not guaranteed by the bank. Moreover, the OCC's Advisory emphasizes that banks need to ensure that only qualified people are selling insurance, and that insurance is sold in areas that are separate from traditional banking functions, *e g*., deposit taking, to the extent practicable.

governmental interests, such as maintaining the safety and soundness of the banking system and ensuring that consumers are adequately protected. Our concerns over the current version of H.R. 10 arise from the inclusion of provisions that diminish safety and soundness and fail to remove existing barriers to product diversification and competition, and thus do not meet the essential requirements of true financial modernization.

Most Common Nonbank Subsidiaries of Bank Holding Companies and Banks: 1996[1]

Type of Nonbank Subsidiary	Number of Subsidiaries, Bank Holding Companies	Number of Subsidiaries, Banks
Consumer finance	318	124
Leasing personal or real property	191	365
Mortgage banking	129	201
Debts previously contracted activities[2]	27	494
Debts previously contracted activities[3]	25	196
Data processing	123	96
Insurance agency or brokerage services[4]	72	74
Commercial finance	46	39

[1]Data as of September 30, 1996. Includes all direct subsidiaries of the bank or holding company. All banks in the analysis were members of holding companies. Source: Federal Reserve Board National Information Center.

[2]DPC activities (91BB) Company organized to liquidate assets acquired from the parent BHC or its banking subsidiaries.

[3]DPC activities (91BA) Company organized to acquire assets in lieu of debts previously contracted.

[4]Insurance agency or brokerage services related to credit insurance.

NEWS RELEASE

Comptroller of the Currency
Administrator of National Banks

NR 87-75

Washington, D.C. 20219

For IMMEDIATE RELEASE

Date October 26, 1987

The Office of the Comptroller of the Currency today entered into a consent order with the board of directors of Continental Illinois National Bank and Trust Company relating to Continental's subsidiary, First Options of Chicago, Inc. First Options is a registered broker/dealer and futures commission merchant which was acquired by Continental with the Comptroller's approval in December 1986.

In granting approval, the Comptroller placed certain limits and conditions on Continental's relationship with First Options. Among the conditions for approval of the acquisition was the following: "The Bank's investment in, and loans to, First Options may not exceed in the aggregate an amount equal to the Bank's legal lending limit at the time of the investment or loan of any funds. The bank shall not make any additional investment of equity capital in First Options without prior written consent of the Office."

The effect of this condition was to limit Continental's total investments in and advances to First Options to an amount not exceeding what Continental could lend to other unaffiliated companies. The restrictions were designed to limit Continental's exposure from any of the operations of First Options. However, First Options can and does receive financial support from Continental's bank holding company parent, Continental Illinois Corporation.

Today's action resulted from the Comptroller's finding that Continental had exceeded the limits imposed on its investment in and advances to First Options. The Comptroller determined that the violation occurred and was corrected during last week's extraordinary activities in the securities markets.

The consent order enforces the conditions imposed in the Office's December 1986 approval and requires the bank to continue to comply with those conditions. The action evidences the Office's continuing commitment to properly insulating national banks from possible risks associated with their operating subsidiaries.

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Cornell Law Review
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***1036 PIERCING THE CORPORATE VEIL: AN EMPIRICAL STUDY**

Robert B. Thompson [FNd]

I

INTRODUCTION

Piercing the corporate veil is the most litigated issue in corporate law [FN1] and yet it remains among the least understood. As a general principle, corporations are recognized as legal entities separate from their shareholders, officers, and directors. Corporate obligations remain the liability of the entity and not of the shareholders, directors, or officers who own and/or act for the entity. "Piercing the corporate veil" refers to the judicially imposed exception to this principle by which courts disregard the separateness of the corporation and hold a shareholder responsible for the corporation's action as if it were the shareholder's own. The boundaries of this exception are usually stated in broad terms that offer little guidance to judges or litigants in subsequent cases. In 1926, Benjamin Cardozo described this corner of the law as "enveloped in the mists of metaphor," [FN2] and courts and commentators have been even less kind in ***1037** subsequent years. Legal writers have described judicial decisions to pierce the veil as "irreconcilable and not entirely comprehensible," [FN3] "defy[ing] any attempt at rational explanation," [FN4] and occurring "freakishly." [FN5]

Much of the criticism, like Cardozo's comment, is directed more at the form and language of the decisions than at the results. A common refrain in the literature is an attack on the use of conclusory terms, such as "alter ego" and "instrumentality," [FN6] that provide no insight into the nature of the factors considered. Commentators lament that the same facts appear in cases providing relief and cases denying relief [FN7] in an unpatterned mingling of relevant with neutral facts that has stymied constructive analysis. [FN8] The law is presented as offering completely antithetical doctrines [FN9] which courts are at liberty to utilize or ignore, depending upon the results desired. [FN10]

Despite this barrage of negative reviews, many believe that beneath this layer of unhelpful language courts are getting it right. An early scholar in this area, Elvin Latty, observed that, "in spite of conflicting and misleading dicta the judicial hunch usually carries through to a correct decision." [FN11] Adolf Berle wrote, "[t]he various reasons, fictions, arguments and important considerations are many, diverse, and frequently inconsistent; but the scheme of these various ***1038** exceptions is none the less consistent and logical enough." [FN12] More recent scholarship has echoed these conclusions, [FN13] with some notable dissent arguing that current law is inadequate to deal with the concerns of tort victims [FN14] or the problems of corporate groups. [FN15]

Much of the legal scholarship in this area reflects scholars' efforts to reveal the decisional structure beneath the verbal shabbiness of the law's facade. This search has produced checklists of varying lengths [FN16] as well as more general theories of factors that should produce different results. For example, commentators have suggested that contract cases should be treated differently from tort cases, [FN17] or predicted that corporations with individuals as shareholders will be treated differently in a piercing context than corporations with other corporations as their shareholders. [FN18]

This empirical study evaluates these claims about piercing the veil cases by analyzing the nature of the corporations, the plaintiffs, the courts, and the reasons given by the courts for piercing or not piercing the corporate veil. The results suggest that the factors affecting the judicial outcome are not necessarily as suggested by previous commentary. For example, courts pierce less often in tort than in contract contexts, and a piercing

decision is not less but more likely when the shareholder behind the veil is an individual rather than another corporation. Other results confirm prior predictions. For example, the likelihood of piercing increases as the number of shareholders decreases. Factors frequently cited by commentators, such as misrepresentation and undercapitalization, do make a difference, but this difference is more pronounced in contract settings than in tort or statutory settings.

The results of analyzing the entire data set demonstrate that the ***1039** question of piercing the veil is contextual Most significantly, piercing occurs only in close corporations or within corporate groups; it does not occur in public corporations. When piercing does occur, the courts' reasoning varies with the context, and decisions reflect the differing impact of various statutory policies affecting limited liability. The traditional reasons for piercing work best in bargain or contractual settings and less well in torts or statutory cases. Part II of this Article provides an overview of the law of piercing the corporate veil. Part III describes the methodology used in this project. Part IV describes the empirical results of the project, particularly as they affect various theories put forward in this area. The final part offers some conclusions as to piercing-the-veil law that can be drawn from the empirical results.

II

THE LAW OF PIERCING THE CORPORATE VEIL

A fundamental principle of corporate law is that shareholders in a corporation are not liable for the obligations of the enterprise beyond the capital that they contribute in exchange for their shares. [FN19] A corollary of this principle is that the corporation is an entity separate from its shareholders, directors, or officers. [FN20] Such limited liability was not always the rule in American law, [FN21] but it has been accepted in most American jurisdictions since the mid-nineteenth century. [FN22]

Limited liability permits parties to allocate the risk of an enterprise to a more efficient risk-bearer in particular circumstances. The possibility that the failure of a business would allow its creditors to reach all of an investor's nonbusiness assets might deter a risk-averse investor from investing, even though that possibility is small and the investment has a positive net present value. Limited liability encourages these investments. [FN23] Creditors of a limited liability enterprise bear more risk than do creditors of an identically funded enterprise where the creditors can pursue the nonenterprise assets of the investors. Creditors who choose to deal with a limited liability enterprise accept this risk and can raise their prices to reflect this ***1040** difference in risk or can seek security. [FN24] This shift in potential liability from shareholders to creditors produces gains for society if the creditors are more efficient in evaluating or bearing particular risks. [FN25] However, even if creditors are sometimes better risk-bearers, limited liability also shifts risks in other situations to claimants who had no choice in dealing with the enterprise (for example, tort victims or small uninformed creditors). To this extent, limited liability shifts some costs of doing business away from the corporation to other parts of society. [FN26]

Limited liability encourages development of public markets for stocks and thus helps make possible the liquidity and diversification benefits that investors receive from those markets. [FN27] Without limited liability, the risk each investor would face in investing in an enterprise would turn in part on the wealth of other investors. [FN28] Such a system would have search costs and other costs which would likely lead investors to make a few larger investments where risk-assessment information was accessible, and perhaps entail a reduced level of economic activity across the entire economy. [FN29]

The separateness of the corporate entity, most often used to protect those behind the veil from additional liability, also serves to ***1041** insure the shareholder's entitlement to certain benefits that would not be available if the line between the corporation and its shareholders were disregarded. For example, shareholder-employees of a corporation may qualify for social security [FN30] or unemployment benefits [FN31] that would be reduced or unavailable if the corporation were disregarded. A separate entity may also be used to divide those parts of an enterprise which are subject to specific government regulation, such as insurance, banking, securities, or

communications, from other parts of the enterprise that do not fall within the regulated area. The unregulated part of the business is free of the costs of regulation that it might not avoid were the enterprise considered as a whole [FN32]

These purposes support the general rule that the separateness of a corporation from its shareholders will normally be respected. Yet this principle is not absolute, and courts regularly disregard the entity when its separateness is used for illegitimate purposes. A federal court at the turn of the century summarized the reasons to overcome separateness as "when the notion of legal entity is used to defeat public convenience, justify wrong, protect fraud, or defend crime." [FN33] Professor Ballantine was even more general: "it comes down to a question of good faith and honesty in the use of corporate privilege for legitimate ends." [FN34]

Resolution of a piercing question is almost always left to a judge's determination of corporate illegitimacy. Almost all state corporations statutes simply ignore the whole idea of piercing the corporate veil. The Model Business Corporation Act provides that shareholders are not personally liable for the acts or debts of the corporation unless the articles of incorporation provide otherwise or the shareholder becomes personally liable "by reason of his own ***1042** acts or conduct." [FN35] That last phrase is not further defined, nor is there any hint as to how much, if any, of the common-law doctrine of piercing the corporate veil is to be covered by this phrase. As the official comment to section 6.22 states, the section "sets forth the basic rule of nonliability of shareholders for corporate acts or debts that underlies modern corporation law." [FN36] Delaware's statute permits a corporation to include in its certificate a provision imposing personal liability, but otherwise the stockholders are not "personally liable for the payment of the corporation's debts except as they may be liable by reason of their own conduct or acts." [FN37]

A recent exception to this legislative silence is a 1989 Texas statute that limits a shareholder's liability for fraud arising from a corporation's contractual obligations "unless the obligee demonstrates that the [shareholder] caused the corporation to be used [for] actual fraud . . . , primarily for the direct personal benefit of the [shareholder]." [FN38] Another provision purports to block shareholder liability for a corporation's contractual obligations based on absence of corporate formalities. [FN39] That statute appears to be a response to a Texas case that pierced the corporate veil on very broad grounds, [FN40] and it seeks to toughen case law at least in contractual contexts But the statute's focus on fraud and informalities addresses neither noncontractual contexts nor the many other reasons courts give for piercing the veil in a contractual context, such as undercapitalization and commingling of funds. The Texas statute still leaves courts as the primary law-makers for piercing the veil.

***1043** The growth in federal legislation since the 1930s has changed the judicial role somewhat. Some statutes, like the federal securities laws, explicitly cover controlling shareholders and may explicitly mention subsidiaries or affiliates. [FN41] Other statutes use more generic terms such as "employer," "owner," or "operator," leaving definition of the scope of the terms to subsequent development. [FN42] Courts must determine if the specific statutory policy mandates less respect for the corporate form than would arise from the usual application of corporate law alone.

The continuing reliance on case instead of statutory law, and a parallel judicial reliance on case-by-case resolution in lieu of far-reaching standards, reflects the nature of the conduct being regulated. As with insider trading [FN43] and much of the law of directors' fiduciary duties, [FN44] additional specification may not be possible without inviting greater abuse, as investors and their lawyers plan transactions to avoid specific terms of the law. [FN45] For example, state corporations statutes limit the dividends that may be paid to shareholders, [FN46] but this bright-line rule has not removed the need for "piercing" as an alternative constraint to regulate shareholders who leave their corporation with few assets. Courts and legislators have chosen to rely on after-the-fact adjudication based on general principles in lieu of more specific standards.

This uncertainty in legal standard does not, however, reduce the business participant's desire to predict ultimate judicial outcomes. Toward that end, this project seeks to provide some empirical data on the factors used by courts in deciding whether to pierce the corporate veil.

THE METHODOLOGY OF THIS PROJECT

A. The Data Set

This project includes all Westlaw cases through 1985 concerning the issue of piercing the corporate veil. [FN47] Those cases that did not address corporate law were eliminated from the initial set of 2000, leaving a pool of about 1600 cases for which both factual and analytical data were collected. [FN48] The factual data compiled from each case included: whether or not the court pierced the veil; year; court; which jurisdiction's law was being applied; the number of shareholders in the corporation that was the object of piercing; whether a person or an entity was behind the corporate veil; the person or entity seeking the piercing; the substance of the claim (contract, tort, criminal law, or a specific statute); and whether or not the claim involved procedure. [FN49]

In addition to this factual data, the reasons courts gave to explain their decision to either pierce or not pierce the corporate veil were collected. These were less objective than the inquiries made above and reflected a judgment by the court to cite the presence or absence of certain factors. The data-gathering form included a universe of eighty-five reasons gleaned from previous research in the area and a sampling of the cases in the data set. These reasons were grouped into several major categories: undercapitalization; [FN50] failure to follow corporate formalities; [FN51] overlap of corporate records, functions or personnel; [FN52] misrepresentation; [FN53] shareholder domination; [FN54] ***1045** intertwining and lack of substantive separation; [FN55] use of the conclusory terms "alter ego" [FN56] and "instrumentality"; [FN57] the general ground of fairness; [FN58] assumption of risk; [FN59] refusal to let a corporation pierce itself; [FN60] and statutory policy. [FN61] Courts frequently give more than one reason for their decisions; multiple reasons were recorded where listed by the court.

B. Methodology Questions

This study provides data beyond that previously assembled on ***1046** the question of piercing the corporate veil. [FN62] As with any empirical study, it is worthwhile to keep in mind what the study can and cannot do. These results are based on reported cases that may not be a representative sample: of all piercing the veil cases actually decided (since many opinions are not reported); of all piercing the veil cases actually filed (since most cases are settled); or of the total number of transactions in which a "piercing" question comes up (since many questions are resolved without litigation). [FN63] These limitations make it inappropriate to draw conclusions as to the number of corporations in which the question of piercing the corporate veil arises. As Richard Posner has written, one reading only veil piercing cases would assume that the purpose of the corporate affiliation is to mislead creditors. [FN64]

The literature on selection bias (including the work by Priest and Klein [FN65] and Priest alone [FN66]) suggests that disputes selected for litigation will constitute neither a random nor representative sample of the set of all disputes. Any relative comparison of various factors, such as the one done here can be affected to the extent that litigants understand the prior learning on a legal issue and use that knowledge to decide which cases to file, to continue on appeal, or to settle. [FN67] While that type of selection might be occurring in this set of reported opinions, other factors suggest that the bias is not so great as to prevent meaningful uses of differences in the results. First, as the previous section discusses, the law in this area has not crystallized. [FN68] Case results are very fact specific, and the fact patterns that cause a court to pierce or not to pierce are not clearly understood. The area of uncertainty is broad enough that litigants have continued to bring a large number of cases. Second, the lack of any significant change over time in the percentage of cases in which courts ***1047** pierce the veil, or any significant difference between results in state and federal court cases or between results in trial, appellate, and supreme court cases, suggests that the sample has stayed within the same broad range. [FN69] Finally, to the extent that these results are used to evaluate theories in prior commentary, this study uses a data set broader than the sample of reported cases that form the basis for the comments previously put forward.

EMPIRICAL RESULTS

A. The Frequency Distributions

1. General Observations

Some initial observations can be made based on review of the entire data set. Piercing of the corporate veil is limited to close corporations and corporate groups (parent/subsidiary or sibling corporations). [FN70] In the entire data set, piercing did not occur in a publicly held corporation. [FN71] This universal respect for the separateness of the corporate entity in publicly held corporations reflects the different role that limited liability plays in larger corporations. All corporations can use the corporate form to allocate risk. [FN72] Limited liability performs the additional function in larger corporations of facilitating the transferability of shares and making possible organized ***1048** securities markets with the increased liquidity and diversification benefits that these markets make possible [FN73] The absence of these market-related benefits for close corporations [FN74] explains, in part, why courts are more willing to pierce the veil of close corporations, but a piercing result still requires a combination of other factors. The total absence of piercing in public corporations permits a stronger positive statement for those corporations: the market-related benefits of limited liability are sufficient to prevail over all possible claims of those who have claims against the public corporation and cannot collect from its assets.

A subsidiary corporation has sometimes been termed a special variation of a o.ne shareholder corporation, a view that would make piercing entirely a close corporation doctrine. However, the data illustrate that piercing cases in which the corporation's shareholders are individuals differ in several ways from the cases in which the shareholder is another corporation, so that there is value in describing piercing for close corporations separately from piercing within corporate groups. [FN75]

Courts pierced the veil in about 40% of reported cases

TABLE ONE

Category	All cases	Pierce	No Pierce	% Piercing
#	1583	636	947	40.18

The remainder of this article examines factors which lead to piercing percentages different from the overall percentage shown in Table 1. Before evaluating these factors consider first the factors that do not appear to have any significant effect on the results:

-- There is no trend over time. Courts do not appear to be moving toward permitting piercing in more and more situations. [FN76] ***1049** While there are variations from year to year, the percentage of cases in which courts pierce the veil has stayed relatively constant over the last several decades. [FN77]

TABLE TWO

Category	Total number of cases	Pierce	No Pierce	% Piercing
Pre-1960	130	53	[illegible]	40.77
1960s	399	164	235	41.10
1970s	572	233	339	40.73
1980s	484	187	297	[illegible]

-- State courts pierce the veil in about the same percentage of cases as federal courts. [FN78]

TABLE THREE

Category	Total Number of cases	Pierce	No Pierce	% Piercing
State Courts	938	369	569	39.34
Federal Courts	647	268	379	41.42

-- Trial, appellate, and supreme courts pierce in a similar percentage of cases. [FN79]

*1050 TABLE FOUR

Category	Total number of cases	Pierce	No Pierce	% Piercing
Trial Courts	401	161	240	40.15
Intermediate App.	860	338	522	39.30
Supreme Courts	316	133	183	42.09

-- The identity of the plaintiff as either an individual or a corporation leads to no differences in results. [FN80]

TABLE FIVE

Category	Total number of cases	Pierce	No Pierce	% Piercing
Individual Plaintiff	695	262	433	37.70
Corporate Plaintiff	652	240	412	36.81

-- Creditors and noncreditors have similar success rates in cases they bring as plaintiffs. [FN81]

2. Differences by State

The percentage of cases in which courts pierce the veil varies depending on which state's law is being applied. Among the eight states with the most piercing decisions, the percentage of cases in which courts pierced ranged from 31% in Pennsylvania and 35% in New York to 45% in California. [FN82] Given the small number of cases in each jurisdiction, the differences between the states are not statistically significant. Therefore, it is not possible to say with certainty

*1051 TABLE SIX

Category	Total number of cases	Pierce	No Pierce	% Piercing
AK	10	3	7	30.00
AL	17	11	6	64.71
AR	23	9	14	39.13
AZ	17	7	10	41.18
CA	89	40	49	41.94
CO	13	7	6	53.85

CT	11	7	4	63.64
DC	10	6	4	60.00
DE	11	0	11	0.00
Federal	302	119	183	39.40
FL	46	19	27	41.30
GA	47	18	29	38.30
HA	4	1	3	25.00
IA	12	7	5	58.33
ID	9	6	3	66.67
IL	78	33	45	42.31
IN	16	11	5	68.75
KS	19	15	4	78.95
KY	15	4	11	26.67
LA	67	24	43	35.82
MA	15	6	9	40.00
MD	15	6	9	40.00
ME	8	2	6	25.00
MI	22	6	16	27.27
MN	13	5	8	38.46
MO	30	12	18	40.00

MS	14	5	9	35.71
MT	8	4	4	50.00
NC	21	9	12	42.86
ND	4	3	1	75.00
NE	12	7	5	58.33
NH	5	0	5	0.00
NJ	20	9	11	45.00
NM	13	2	11	15.38
NV	12	5	7	41.67
NY	212	74	138	34.91
OH	14	8	6	57.14
OK	15	6	9	40.00
OR	16	9	7	56.25
PA	65	20	45	30.77
PR	3	0	3	0.00
RI	6	2	4	33.33
SC	8	3	5	37.50
SD	8	5	3	62.50
TN	18	7	11	38.89
TX	106	37	69	34.91

UT	7	3	4	42.86
VA	16	4	12	25.00
VT	0	0	0	0
WA	27	12	15	44.44
WI	16	8	8	50.00
WV	7	3	4	42.86
WY	8	5	3	62.50

***1052** that these results are dueto different views of the law. [FN83]

The higher percentage of piercing in California cases may reflect that state's relative lateness in embracing the doctrine of limited liability. Until 1931, shareholders in California corporations remained liable for at least some of a creditor's claim against the corporation. [FN84] Each shareholder was liable for the proportion of each creditor's claim that corresponded to the shareholder's proportional ownership in the stock of the corporation. [FN85] This liability expired three years after the date on which corporate liability was incurred and was subject to other limitations. [FN86] It is uncertain how often this liability was asserted, but the statute probably contributed to a perception that public policy in California favored piercing the corporate veil.

New York, as this country's leading commercial center, has produced the most piercing cases. As a group, the New York decisions seem somewhat more restrictive on piercing than cases from the rest of the country. [FN87] Delaware, clearly the most dominant state in corporate law, has produced very few piercing cases. [FN88] This result is consistent with viewing piercing as a close corporation issue, [FN89] since Delaware's traditional focus has been on large corporations where there is a separation of function between managers and shareholders. [FN90] Using Delaware law, courts did not pierce in any of the ***1053** eleven reported cases. This fact may reflect the larger size of Delaware corporations or a general leaning toward protecting corporations in that jurisdiction. [FN91]

Knowledge of differences between states is useful only when parties to the litigation can predict and choose which state law will be applied. Potential defendants, who almost always are corporate insiders, can choose the state of incorporation. [FN92] Those who have chosen a restrictive piercing jurisdiction would argue that a court should apply the "internal affairs" rule and apply the laws of the state of incorporation to the piercing decision. [FN93] The internal affairs rule is a choice of law principle under which the laws of the state of incorporation govern arrangements between shareholders and managers. [FN94] A few states, including New York and California, have asserted by statute their right to apply their own law to corporations incorporated in other states. [FN95] These statutes do not specifically list piercing, which is a common-law doctrine in all states, but it seems likely that a state which aggressively applied its corporations statute would apply its common law in the same way.

Piercing the veil cases may not be governed by the internal affairs rule even if that rule is applied to foreign corporations. The dispute in a piercing case is not between shareholders and managers, the traditional province of

the internal affairs rule, but between the corporation's insiders and persons or entities who contracted with the enterprise or who are connected to the enterprise ***1054** by tort or other laws. [FN96] The Restatement (Second) of the Conflict of Laws suggests that the rule favoring the law of the state of incorporation extends to questions of liability to creditors. [FN97] Yet states other than the state of incorporation have sometimes asserted the right to apply their own statutes in order to protect their citizens who are tort victims or creditors of out of state corporations. [FN98] Such a connection with potential plaintiffs may give a non-incorporating state a link to the transaction sufficient enough so that it can assert the applicability of its laws. This can create uncertainty if multiple states seek to apply differing rules of limited liability to the same corporation. However, given the small number of piercing cases decided in many jurisdictions and the similar results in many states, this degree of uncertainty does not seem large. [FN99]

Knowledge of the differences between state approaches will probably be of greater use to prospective plaintiffs, who, given a choice, would rather file in a state whose results are more inclined to piercing. Even if a forum state agrees to apply the law of the more restrictive state of incorporation, the piercing law in all jurisdictions leaves considerable room for judicial discretion; a plaintiff may prefer this discretion to be exercised by a judge from a more friendly "piercing" culture.

3. Differences Based on the Number and Identity of the Shareholders

The number of shareholders makes a difference in the propensity of courts to pierce the veil of corporations. Among close corporations, those with only one shareholder were pierced in almost ***1055** 50% of the cases; for two or three shareholder corporations, the percentage dropped to just over 46%, and for close corporations with more than three shareholders, the percentage dropped to about 35%. The differences between the one, two or three person corporations, and the other close corporations are statistically significant. [FN100]

TABLE SEVEN

Identity of Shareholders	Total number of cases	Pierce	No Pierce	% Piercing
Individuals: -- One	276	137	139	49.64
-- Two or Three	238	110	128	46.22
Close but -- More than Three	263	92	171	34.98
-- Public Shareholders	9	0	9	0.00
Total Individuals	786	339	447	43.13
Corporate: -- Parent	386	142	244	36.79

-- Subsidiary	68	19	49	27.94
-- Sibling	183	76	[illegible]	[illegible]
Total Corporate	637	237	[illegible]	37.21

Since the 1897 decision of the House of Lords upholding the limited liability of what was essentially a one person corporation, [FN101] courts and commentators have vigorously debated the propriety of limited liability for these enterprises. [FN102] Lord Herschell in that case asked, "[h]ow does it concern the creditor whether the capital . . . is owned by seven persons . . . or . . . almost entirely owned . . . by one ***1056** person?" [FN103] The results show that the number of shareholders seems to matter to judges. However, it is not, as some have suggested, virtually impossible for one person corporations to retain limited liability in any circumstance. [FN104] Even though many of the factors used by courts to justify piercing the veil are inescapable in one person corporations, [FN105] these corporations still retain limited liability in half of the reported cases.

The role that an individual plays within a corporation also has an effect on the outcome. Defendants who served only as shareholders were less likely to be successful targets of piercing suits than shareholders who also served as directors or officers. [FN106] Further, in the few cases that characterized potential defendants as passive shareholders rather than active in the business as directors, officers, or otherwise, the courts almost always found no liability. [FN107]

4. Differences Based on Whether the Defendant is an Individual or a Corporation

When potential defendants against whom liability is sought are grouped as either individuals or corporations, courts pierce the veil to get at individual defendants more often than they pierce to reach corporations. [FN108] This result is contrary to what some commentators have suggested. [FN109] However, if the one or the two or three person corporations are excluded from this count, the courts pierce more often to reach shareholders who are corporations. [FN110]

Among potential corporate shareholders, courts are more inclined ***1057** to pierce when the potential liability is directed at sibling corporations, and less inclined to pierce when a plaintiff seeks to look through a parent to get to a subsidiary. [FN111]

5. Differences Based on the Identity of the Plaintiff

Although the identity of the potential defendant as either an individual or a corporation did contribute to differences in result, [FN112] the identity of the plaintiff as either an individual or a corporation did not have an impact. [FN113] The most successful plaintiffs were governmental entities, and the least successful were the corporations themselves and shareholder seeking piercing of their own corporation.

TABLE EIGHT

Category	Total number of cases	Pierce	No Pierce	% Piercing

Creditor Plaintiff	612	259	353	42.32
Noncreditor Plaintiff	514	207	307	40.27
Government Plaintiff	218	126	92	57.80
Corporate (self) Plaintiff	164	22	142	13.41
Shareholder Plaintiff	59	15	44	25.42

The differences between the government or corporate plaintiffs and the creditor plaintiffs are statistically significant. [FN114] The government's success often comes in the context of a statutory policy, as opposed to a contract or tort context.

The corporation itself seldom is successful in arguing self- piercing. ***1058** Courts tell participants that they chose the form of the enterprise and that they are stuck with it in bad times as well as in good. [FN115] Yet the willingness of courts to pierce the veil in one out of every eight of these cases shows the contextual nature of the corporate form. The form is preserved in some situations but not others, and judicial decisions are required to determine the appropriate contexts for preservation.

6. Differences Based on the Substantive Context in Which the Claim Arose

When the cases are broken down based upon whether they arose in a contract situation or a tort situation, the results show that courts pierce more often in the contract context than in tort context. This difference is statistically significant. [FN116]

TABLE NINE

Context	Total Cases	Pierce	No Pierce	% Piercing
Contract	779	327	452	41.98
Tort	226	70	156	30.97
Criminal	15	10	5	66.67
Statute	552	224	328	40.58

When the question is asked a slightly different way--did the transaction that was the subject of the piercing result

from voluntary contact or involuntary contact?--the results are similar to those obtained in contract and tort cases, respectively. [FN117]

These results, more than any other in the project, go against the conventional wisdom. [FN118] Many commentators have noted that ***1059** tort claimants have a better claim to piercing the veil because they did not choose to deal with the corporate enterprise that ultimately was unable to pay its obligation. [FN119] In contrast, a contract claimant voluntarily dealt with the corporate entity, had a greater opportunity to evaluate the credit risks, and could have chosen not to deal with the corporation. According to this reasoning, courts should pierce more readily in tort settings. [FN120] The next part of this Article examines several factors in an attempt to explain the variance of these results from conventional expectations. As the next part illustrates, a large segment of the contract cases, but not the tort cases, arise in situations where the court is concerned with possible misrepresentation, and courts pierce the veil in almost all cases in which they find misrepresentation. [FN121] But even if misrepresentation cases are deleted from the contract and tort cases, courts still pierce more often in contract than in tort.

7. Differences Based on Procedure

Jurisdiction and other procedural cases raise different issues than the more ordinary contract and tort questions in veil piercing jurisprudence. For example, in Cannon Manufacturing Co. v. Cudahy Packing Co., [FN122] a North Carolina plaintiff sued a parent corporation in North Carolina on the basis of the North Carolina activity of a ***1060** wholly-owned subsidiary. The United States Supreme Court concluded that the subsidiary was a separate and distinct corporate entity and that jurisdiction over the parent was lacking. In contrast, later courts have been more willing to find jurisdiction; for example, the California Supreme Court found jurisdiction in Empire Steel Corp. v. Superior Court, [FN123] holding that a parent was doing business in California by reason of its interrelationship with its subsidiary.

An early article by Professors Douglas and Shanks noted the different context of the jurisdiction cases and dismissed them from further discussion. [FN124] More recently, Professor Blumberg has emphasized the different concerns in procedural cases: fairness and convenience to the parties, federalism concerns, and an entity's reasonable expectations of being called into court in a forum where it derives income from its affiliates' business. [FN125] In the procedural area, Blumberg sees enterprise law and a focus on corporate groups as replacing the entity concept and the concern for limited liability. [FN126] Other commentators and courts have suggested that a more lenient standard applies in deciding whether to pierce the veil in order to establish jurisdiction, than in deciding whether the links are sufficient to make the shareholders liable for corporate debts. [FN127] The results in this study do not reflect a greater inclination to pierce when the question is procedural, although there is a higher percentage of piercing in venue cases.

TABLE TEN

Procedure	Total Cases	Pierce	No Pierce	Piercing
Jurisdiction	141	52	89	36.88
Venue	12	7	5	58.33

8. Differences Based on Statutory Claims

Piercing the corporate veil is no longer limited to the common-law contexts of contract and tort. Reflecting the

increasing regulatory bent of our society, courts have been asked to disregard the veil ***1061** in a variety of statutory contexts. These cases clearly show the contextual nature of the piercing the veil question; courts look to the specific context more than any inherent corporate characteristic to determine if the separateness of the corporate form should be respected. Of the 552 cases that raised the piercing question in a statutory context, courts disregarded the separate entity about 40% of the time, [FN128] the same rate as in the overall study. However, there are large disparities depending on the various statutes. For example, in cases involving tax law, courts pierced the veil in only 31% of the cases. [FN129] The federal income tax, like most federal and state tax codes, presumes that the corporation is a taxable entity separate from its shareholders, creating the possibility of double taxation on the income from the enterprise. The corporation is first taxed on its income, and a separate tax is also levied on dividends paid to shareholders by the corporation from the corporation's already taxed income. [FN130] Courts are apparently less inclined to look behind the separate entity in tax contexts.

Workers' compensation is another area where courts are less inclined to pierce, doing so in less than 13% of the cases. [FN131] These cases often involve the issue of whether an injured worker can bring a civil action against a parent or other company related to the worker's employer, in spite of workers' compensation statutes that impose liability without fault as the employee's sole remedy against the employer. Defendant parent corporations often seek to pierce the veil to block a plaintiff's separate suit for recovery against the parent and leave the plaintiff covered only by workers' compensation from the subsidiary. [FN132] Courts' disinclination to pierce the veil usually permits these claims to continue, apparently putting concern for recovery over any corporate law concerns. [FN133]

At the other end of the spectrum, courts are more inclined to pierce in environmental cases [FN134] and other areas where there is a ***1062** strong regulatory purpose, [FN135] including a specific effort to reach related companies or individuals who control companies.

The importance of statutory policy is reflected in less use of such traditional piercing factors as undercapitalization, informalities, and misrepresentation in statutory cases as compared to contract cases. Undercapitalization is present in more than 18% of contract cases in which the courts pierced the veil but is only present in 8% of the statutory cases. [FN136] Similarly, the rate at which informalities and misrepresentation appear in contract cases is nearly double the rate at which these factors appear in statutory cases. [FN137]

***1063** B. Reasons Given by the Courts

The seeming indeterminacy of veil-piercing law reflects not just the conclusory language frequently used by the courts but also the broad range of reasons proffered when the courts attempt to explain their conclusions. As one commentator has noted, the same reasons seem to appear in cases which pierce the veil and those decisions which do not. [FN138] The next section presents the empirical results of the reasons given by the courts, focusing both on the relative frequency with which these reasons appear in piercing cases and the percentage of times that the appearance of these reasons coincides with a piercing result. Subsequent sections analyze in more detail two substantive areas often discussed in connection with piercing: undercapitalization and informalities.

TABLE ELEVEN

	Number of Cases in which factor	Number of Piercing	Number of No-Piercing	Percent[illegible]

Category	mentioned	Results	Results	Pierced
Instrumentality	75	73	2	97.33
Alter Ego	181	173	8	95.58
Misrepresentation	169	159	10	94.08
Agency	52	48	4	92.31
Dummy	78	70	8	89.74
Lack of Substantive Separation	141	120	21	85.11
Intertwining	63	54	9	85.71
Undercapitalization	120	88	32	73.33
Informalities	151	101	50	66.89
Domination & Control	551	314	237	56.99
Overlap:				
Officers	174	87	87	50.00
Directors	152	66	86	43.42
Owners	101	49	52	48.51
Office	68	40	28	58.82
Business Activity	43	35	8	81.40
Employees	52	36	16	69.23
Management	43	28	15	65.12
Other	169	118	51	69.82

Total Overlap	812	459	343	56.53

*1064 1. The Frequency Distribution

The factors most often associated with an affirmative result in a piercing case were not necessarily those that appeared the most often. The group of factors most associated with successful piercing (with the empirical results given in parentheses) included several of the tradition conclusory factors: "instrumentality" (97.33%), "alter ego" (95.58%), and "dummy" (89.74%). Also in this most successful category were cases involving misrepresentation, present in 169 cases and leading to a piercing result 159 times (94%). If a court found intertwining or lack of substantive separation, it pierced the veil more than 85% of the time.

Factors leading less often to a piercing result were under-capitalization (73%) and failure to follow corporate formalities (67%). [FN139] Still further down the success ladder were judicial citations to domination and control (57%) and overlap of various sorts between the corporation and the shareholder (57%). Within this group, courts placed different importance on various kinds of overlap. Where common business activities were cited, the courts pierced 81% of the time; for common employees, 69% of the time; and for common management, 65% of the time. Other commonalities were less often associated with piercing. Courts pierced only 59% of the time when they listed common offices and only half of the time for common officers. Even less important were common directors (courts pierced only 45% of the time when this factor was mentioned) and common owners (49%). These results suggest that courts are looking beyond the formal overlap of shareholders, directors, and officers to see if businesses show other signs of intertwining between the corporation and the shareholder.

The survey form, used to collect information for each case in the data set, also listed factors whose absence was mentioned by the court. [FN140] Courts refused to pierce the veil in at least 92% of the cases in which a factor's absence was noted, and sometimes up to 100% of those cases. Misrepresentation emerges as the factor whose absece was most often noted by courts. [FN141] Courts cited the absence of misrepresentation in 391 cases, almost one-quarter of the cases, and more than twice the number of cases in which the ***1065** presence of misrepresentation is mentioned. [FN142] The absence of overlap of management and other corporate relations is mentioned more than 300 times, as compared to more than 800 cases in which the presence of such an overlap is mentioned. [FN143]

2. Undercapitalization

Undercapitalization is a factor frequently cited by commentators as part of a normative standard in piercing cases. Ballantime said in the 1940s. "[i]t is coming to be recognized as the policy of the law that shareholders should in good faith put at the risk of the business unincumbered capital reasonably adequate for its prospective liabilities." [FN144] Other commentators have gone so far as to conclude that undercapitalization is present in every piercing case [FN145] or that every undercapitalization case should lead to piercing. [FN146] Several commentators see undercapitalization as particularly important in tort-cases as compared to contract cases, [FN147] or as interacting with other factors such as misrepresentation to enhance the likelihood of piercing. [FN148] The results of undercapitalization cases are surprising.

***1066** in light of this commentary;these expectations are not reflected in the results. Of 327 contract cases in which courts pierced the veil, undercapitalization is present only in sixty-one (about 19%); of seventy tort cases in which courts pierced the veil, undercapitalization is present in only nine (just under 13%). A piercing result was somewhat more likely in the tort cases in which undercapitalization was present (75%) than in contract cases (70%), but the small number of tort cases in which undercapitalization is mentioned decreases the impact of this difference. [FN149] In both contexts, courts refused to pierce in 25 to 30% of the cases even when undercapitalization was present, belying any automatic predictive value for that factor

Undercapitalization was mentioned in only 8% of the statutory cases, which is somewhat less than the percentage for tort cases, and less than half of the contract case percentage. The court pierced in 82% [FN150] of these statutory cases, more than for either torts or contract cases. [FN151]

The presence of undercapitalization was noted in about the same percentage of successful piercing cases involving close corporations, parent-subsidiary corporations, and sibling corporations (between 10% and 12%). [FN152] Its presence was noted in a larger percentage of sole shareholder cases (14.5%) and in a much larger number of cases involving two or three shareholders. Undercapitalization appeared in over 24% of two- or three-shareholder cases in which the courts pierced the veil. [FN153] Yet, overall, undercapitalization appears in a small minority of the cases. [FN154]

Undercapitalization and fraud in the same setting do not explain a large number of cases. Of 636 cases in which courts pierced the veil, either undercapitalization or misrepresentation was present ***1067** in 222 (about 35%), but both were listed as present in only 25. Misrepresentation was present in slightly over 28% of the undercapitalization cases in which the court pierced (twenty-five of eighty-eight). Undercapitalization was present in just under 16% of the misrepresentation cases in which the court pierced (25 of 159). These results indicate that misrepresentation has some predictive value in undercapitalization cases, but still more than 70% of the successful undercapitalization cases do not mention misrepresentation.

As cited in the last section, undercapitalization is not among the factors most frequently cited by the courts in piercing the veil, [FN155] nor is it among the factors associated with the greatest likelihood of piercing. [FN156] The relative infrequency with which courts cite undercapitalization in tort- related piercing cases suggests it is an issue that appeals to commentators for reasons other than its predictive significance.

3. Informalities

Judicial reliance on a corporation's failure to follow corporate formalities as a basis for piercing the veil has been criticized as theoretically unsound. [FN157] Other commentators note that courts nearly always cite disregard of formalities, and that failure to maintain formalities substantially increases the probability of piercing. [FN158] Again the results do not provide confirmation for the commentary. Of 151 cases in which courts cited a corporation's failure to follow corporate formalities, courts pierced the veil in 101 (just under 67%). That percentage of piercing is a little less than the percentage for undercapitalization, and is well below the results in several other categories where the success rate for piercing was in the 85% to 95% range. [FN159]

Informalities are cited in 20% of the contract cases in which courts pierced, as compared to about 11% of the tort and statutory cases in which courts pierced. [FN160] That difference between contract ***1068** and tort is similar to the results for undercapitalization. [FN161] However, unlike undercapitalization, the outcome varied among the three categories of cases. The courts pierced in 61% of the contract cases with informalities (as compared to 70% for undercapitalization); 53% of the tort cases with informalities (compared to 75% for tort cases with undercapitalization); and 40% of the statutory cases with informalities (compared to 82% for statutory cases with undercapitalization). [FN162] Thus, the factor of corporate informalities is more important for contract cases than for other cases, both in the number of times it is used and its likelihood of coinciding with a piercing result. There is some connection between informalities and misrepresentation; [FN163] of 101 cases in which the court pierced and cited informalities, twenty-four also mentioned misrepresentation.

4. Contract versus Tort

Most commentators separate contracts from tort, arguing that a tort context presents an entirely separate problem from contract in piercing the corporate veil, and suggesting that courts should be much more willing to disregard the corporate entity and reach the shareholders when a tort has been committed. [FN164] Commentators cite a moral hazard problem: insiders in a limited liability corporation can transfer costs of accidents to those who deal with the corporation. [FN165] Surprisingly, in light of these theories, the results of the cases show a smaller

percentage of tort cases than contract cases in which the court pierced the veil. [FN166]

The relative absence of tort cases in piercing jurisprudence (only 226 as compared to almost 800 contract cases) suggests that piercing law is rooted in concerns of inequitable bargains. The results seem to confirm Robert Clark's point that the most recurring problems in the piercing area are fraudulent transfers and similar ***1069** contract-related claims. [FN167] However, even if we eliminate the misrepresentation cases from the contracts group, the piercing results still remain higher in contract cases. [FN168] Courts pierced in about 34% of the nonmisrepresentation contract cases as opposed to 27% of the nonmisrepresentation tort cases. [FN169] Undercapitalization, which many commentators believe should cut more strongly in favor of piercing the veil in tort, [FN170] can explain only a small portion of the tort cases. Courts pierced in nine of the twelve (75%) tort cases in which undercapitalization was cited as compared to sixty-one of eighty-seven contract cases (slightly more than 70%) in which undercapitalization was mentioned by the court. The impact of this small difference is reduced by the fact that the undercapitalization factor is less often cited in tort than in contract cases. Overall, tort settings seem to involve different concerns than contracts cases.

The lower percentage of piercing in tort cases is interesting because more than two-thirds of the tort cases involve corporate defendants (either a sibling, parent, or subsidiary). [FN171] This combination of a corporate deep pocket and a nonvoluntary claimant suggests that the plaintiff would have a greater chance of success. [FN172] Yet courts pierce the veil in less than one quarter of the parent-subsidiary cases where the plaintiff alleged a tort claim. There may be some selection bias in this area or the parties may have different stakes in the outcome. [FN173] The change in product-liability law and tort law generally in recent decades may have led plaintiffs to bring suits that go beyond prior law. [FN174] Additionally, the large number of ***1070** corporate defendants may mean that they have more to lose than plaintiffs have to gain, pushing the results in the direction of less piercing. Undercapitalization and informalities are seldom mentioned in these cases.

V

CONCLUSION

Piercing the corporate veil raises the issue of whether the risks of an enterprise can be shifted to parties outside the corporation. The usual corporate law rule of limited liability means that when a corporation is introduced into a transaction, some of the risk in the transaction passes to outside parties. If the corporation's assets are insufficient to pay its debts, creditors, not shareholders, are left exposed.

This rule is not mandatory. Parties are free to change it by providing for individual liability of shareholders. Even if the parties have not changed this rule, a court might accomplish the same result by piercing the corporate veil. Courts essentially treat the rule of limited liability as a presumption that can be rebutted by sufficient facts. The hundreds of cases in which courts have pierced the corporate veil tell us that this presumption can be rebutted. Yet the various factors and lists in cases and commentary create more confusion than clarity as to when disregard of the corporate entity is appropriate. The empirical analysis described in this article removes some of the mist and metaphor by illustrating when the presumption of limited liability holds and when it does not.

First, piercing the corporate veil is a doctrine exclusively directed at close corporations and corporate groups. The total absence of piercing in publicly held corporations indicates the presence of factors in the public corporation setting that make the presumption of limited liability unassailable. It is not that risk cannot be shifted to nonconsenting outsiders by the use of the corporate form, for surely this occurs in public corporations. Nor is the law unwilling to permit passive investors to suffer because of the actions of their managers who act in the name of the entity. The value of shareholders' investments in public corporations declines when civil or criminal liability is assessed against the enterprise because of the acts of officers and other employees. The willingness to sometimes hold shareholders of close corporations liable, but never shareholders of public corporations, suggests that limited liability's ***1071** positive role in facilitating the public market for shares is strong enough to overcome any justification for piercing.

Second, the data suggests that for close corporations, piercing the corporate veil is strongly rooted in the bargain setting. Because the market-related reasons for limited liability are absent in close corporations and corporate groups, the most important justification for limited liability is permitting parties in a consensual relationship to use the corporate form to allocate the risks of the transaction and the enterprise. Thus the presumption of limited liability is strongest when the outside party adversely affected by the corporation's limited assets was aware of the corporation's separate existence at the time of the transaction. Conversely, courts will disregard limited liability for the same reasons that other bargains are not respected by courts. For example, misrepresentation is one of the most frequent factors listed by courts when they pierce the veil.

The principle of limited liability covers more than explicit bargains; it is more than a default rule that simply saves the parties the costs of writing the rule to shift some risk away from shareholders. In addition, it permits the corporate insiders to choose the risk allocation rule without consulting other parties who might be affected. The law respects this choice unless compelling reasons are shown to vary from it. This provides the insiders a degree of certainty in planning, even while it shifts risks to those who did not explicitly contemplate those risks.

The reasons which courts find compelling to rebut the presumption of limited liability often relate to the activity of insiders. Mere ownership of stock (or overlap of ownership in corporate groups) is not sufficient, nor is overlap of shareholders and directors (or common directors within a corporate group). More pejorative conduct is required. Undercapitalization, if found by the court, usually leads to loss of limited liability. Failure to follow corporate formalities also leads to piercing, but more powerful factors are demonstrations of lack of substantive separation of the corporation and its shareholders, and intertwining in the activities of the corporation and its shareholders.

As the fact patterns move completely away from prior consensual interaction between the parties, the presumption of limited liability loses even more of its strength. Limited liability cannot serve a market purpose for corporations whose shares are not publicly traded. It does not appear to serve the purpose of transferring risk to a more efficient risk-bearer; few tort victims would choose the risks involuntarily thrust upon them by a corporation unable to pay for harm caused by its operation. In this setting, respect for the shareholder's limited liability provides predictability to shareholders ***1072** in planning their business affairs with whatever encouragement for investing that predictability might offer. The refusal of courts to pierce in tort settings demonstrates that this "planning" reason can be strong enough to influence the piercing result, even when market or risk-shifting justifications do not apply or cut against respect for the entity.

The reasons that lead courts to drop the presumption in the bargain setting-- for example, misrepresentation, undercapitalization, and failure to follow corporate formalities--also lead to piercing in tort settings, but they are present in many fewer instances. The apparently anomalous results of this study, that courts pierce less often in torts even though the reasons for limited liability appear less strong, probably reflects the "presumption" structure of piercing-the-veil law. To pierce the veil in the bargain setting, something must affirmatively displace the presumption of limited liability. The focus has been on factors (such as misrepresentation or undercapitalization) which show that insiders have abused the privilege of limited liability. Those factors developed in a bargain setting show up less frequently when there has been no prior transaction between the parties. Thus, when courts look for reasons to disregard the presumption, few of the "old reliables" appear. Yet the justification for limited liability is also weak and the traditional piercing doctrine does not easily accommodate this change. The law's use of a presumption of limited liability pushes courts to look for affirmative reasons to disregard the presumption. Courts are left ill-equipped to deal with a typical tort situation within a corporate group when the reasons for limited liability have shrunk to nothing more than the insiders' value of certainty, and yet no affirmative reasons for piercing are present.

What is significant about the tort cases, therefore, is their relative infrequency. Not surprisingly, other doctrines, such as successor liability in products-liability law, have grown to fill some of the gaps. Thus the silence of the tort numbers may be as significant as any factors that are present.

Piercing-the-veil cases arising in statutory contexts also illustrate the weakening of the presumption of limited liability as the situation moves away from a bargain context. As in the tort context, limited liability serves no public market function, nor does it facilitate efficient allocation of risks between parties. Again, the primary issue becomes the value of letting insiders set the allocation of risk by forming corporations and of giving them the planning certainty that would come from not disregarding the corporate entity. As was true with tort, the more common bargain reasons for piercing-- misrepresentation, undercapitalization, and absence of corporate formalities--***1073** do not occur in these statutory contexts as often as in the bargain cases.

Yet, unlike the tort situation, the default rule of corporate law has not been left undisturbed in its respect for the corporate entity and recognition of the choice made by insiders. Rather, the legislature, either explicitly or implicitly, has provided additional guidance on the allocation of risks or benefits available under various statutes. Sometimes the statute provides an explicit broadening of liability as, for example, with the securities laws that regulate certain persons and also those who control, are controlled by, or are controlled in common with the regulated entity. In other areas, the purpose of the law may be implicit or may be developed by administrative interpretation. For example, under the labor laws, the question of whether a corporate form should be disregarded turns not on undercapitalization or other common piercing factors, but on whether there was a common labor policy among the related companies such that a failure to pierce would frustrate the specific purpose of the federal labor laws. [FN175] Other statutes, like the tax laws, reaffirm the presumption of limited liability embodied in corporate law, and so piercing would be expected to occur less frequently.

Thus, this empirical study permits us to see the contextual nature of the piercing-the-corporate-veil question and the structure by which it operates. Limited liability is a presumptive rule of law that facilitates the development of public markets for securities, permits the allocation of risk or benefits between parties, and supports the certainty of planning by those who have organized the corporation. Where there are public markets or where all parties to the transaction participated in the allocation of risk, the law declines to disregard the presumption. In other situations, where the greatest effect of limited liability seems to be only to further the certainty of corporate insiders' planning, the presumption holds unless the insiders have engaged in conduct that makes continuing respect of the bargain unfair.

In addressing tort situations, courts should recognize that the common-law presumption of limited liability was developed to address the allocation of risk in bargain, not tort situations, and that the usual reasons for disregarding the corporate entity do not occur in tort settings. Courts start with the presumption of limited liability, and when none of the usual "suspects" can be found, that presumption continues. If this presumption is going to change, it likely will take legislation or will occur by use of noncorporate legal doctrines.

***1074** Indeed, the key element for courts to recognize in statutory cases is that the legislature has changed the corporate law presumption of limited liability. The focus should not be on the traditional factors for piercing the veil in a bargain setting, but on the extent to which a specific statutory scheme either permits or limits a corporate insider's ability to allocate liability or gain a benefit by forming a corporation. Piercing the corporate veil will remain a judicially applied doctrine, but the varying strength of the presumption of limited liability in different contexts should produce a more understandable body of law that has a greater connection to the normative reasons for limited liability.

FNd Professor of Law, Washington University. Research support for this project was provided by a Treiman Fellowship of the Washington University School of Law. Arbi Ben Abdallah provided invaluable assistance in the statistical aspects of this project, and Deborah Rush provided research assistance. The paper benefited from the comments of Charles Adams, Ian Ayers, Doug Branson, James Cox, John Drobak, Theodore Eisenberg, Ed Greenberg, Frank Kennedy, Stephen Presser, Larry Ribstein, Roberta Romano, Tom Sullivan, and William Wang. The paper was presented at the first meeting of the American Law and Economics Association in May, 1991. I am responsible for any remaining deficiencies.

FN1 This project started with about 2000 cases found in Westlaw, using the search terms, "piercing the corporate veil" and "disregard! the corporate entity" and four Westlaw key numbers. A similar search of Lexis in July, 1990 also

turned up about 2000 cases. By comparison, "corporate takeover" and "hostile takeover" (among the hottest corporate law topics in recent years) appear in fewer than 300 cases. A search for "fiduciary duty" and "corporate" or "director" turned up more than 4000 cases, but that topic includes a multitude of different issues.

FN2 Berkey v. Third Ave. Ry., 244 N.Y. 84, 155 N.E. 58 (1926) (opinion by Cardozo, J.), reh'g denied, 244 N.Y. 602, 155 N.E. 914 (1927). Justice Cardozo wrote:

The whole problem of the relation between parent and subsidiary corporations is one that is still enveloped in the mists of metaphor. Metaphors in law are to be narrowly watched, for starting as devices to liberate thought, they end often by enslaving it. We say at times that the corporate entity will be ignored when the parent corporation operates a business through a subsidiary which is characterized as an 'alias' or a 'dummy'. All this is well enough if the picturesqueness of the epithets does not lead us to forget that the essential term to be defined is the act of operation. Dominion may be so complete, interference so obtrusive, that by general rules of agency the parent will be a principal and the subsidiary an agent. Where control is less than this, we are remitted to the tests of honesty and justice.

Id. at 94-95, 155 N.E. at 61.

FN3 PHILLIP I. BLUMBERG, THE LAW OF CORPORATE GROUPS: PROCEDURAL PROBLEMS IN THE LAW OF PARENT AND SUBSIDIARY CORPORATIONS 8 (1983).

FN4 Jonathan M. Landers, A Unified Approach to Parent, Subsidiary & Affiliate Questions in Bankruptcy, 42 U. CHI. L. REV. 589, 620 (1975).

FN5 Frank H. Easterbrook & Daniel R. Fischel, Limited Liability & the Corporation, 52 U. CHI. L. REV. 89, 89 (1985).

FN6 Robert W. Hamilton, The Corporate Entity, 49 TEX. L. REV. 979, 979 (1971); see Elvin R. Latty, The Corporate Entity as a Solvent of Legal Problems, 34 MICH. L. REV. 597, 621-30 (1936); Note, Judicial Supervision of the One-Man Corporation, 45 HARV. L. REV. 1084, 1089 (1932).

FN7 See Comment, Disregarding the Corporate Entity: Contract Claims, 28 OHIO ST. L.J. 441, 450 (1967) (authored by David C. Cummings) ("[T]he factors of an instrumentality are more or less present in all cases where relief against a shareholder . . . is sought."); see also FREDERICK J. POWELL, PARENT AND SUBSIDIARY CORPORATIONS 9 (1931); Easterbrook & Fischel, supra note 5, at 109; William P. Hackney & Tracey G. Benson, Shareholder Liability for Inadequate Capital, 43 U. PITT. L. REV. 837, 843 (1982).

FN8 John F. Dobbyn, A Practical Approach to Consistency in Veil-Piercing Cases, 19 U. KAN. L. REV. 185, 188 (1971).

FN9 E.R. Latty, A Conceptualistic Tangle and The One-Or-Two-Man Corporation, 34 N.C.L. REV. 471, 472 (1956).

FN10 Note, supra note 6, at 1086.

FN11 Latty, supra note 6, at 630.

FN12 Adolf A. Berle, The Theory of Enterprise Entity, 47 COLUM. L. REV. 343, 345 (1947).

FN13 See, e.g., Easterbrook & Fischel, supra note 5 (economic analysis--in particular the theory of the firm and the economics of insurance--explains the legal treatment of limited liability).

FN14 Note, Should Shareholders Be Personally Liable for the Torts of Their Corporations?, 76 YALE L.J. 1190 (1967) (authored by Arden Doss, Jr.) (limited liability thwarts the objective of modern tort law).

FN15 Phillip I. Blumberg, The Corporate Entity in an Era of Multinational Corporations, 15 DEL. J. CORP. L. 283, 328 (1990) ("the much criticized, irreconcilable, and unpredictable nature of such decisions should leave no doubt as to the fundamental inadequacy of traditional entity law to deal with the problems presented by the new corporate world").

FN16 See, e.g., Cathy S Krendl & James R. Krendl, Piercing the Corporate Veil: Focusing the Inquiry, 55 DEN L.J. 1, 52-55 (1978) (a 31 point checklist); F. POWELL, supra note 7, at 9 (listing 11 factors for application of instrumentality rule).

FN17 See, e.g., Easterbrook & Fischel, supra note 5, at 112; Hamilton, supra note 6, at 984.

FN18 Easterbrook & Fischel, supra note 5, at 111; Landers, supra note 4, at 619 (historical background indicates that limited liability was never intended to protect a parent corporation against liability for the debts of its subsidiary).

FN19 See MODEL BUSINESS CORP. ACT § 6.22(b) (1985).

FN20 The separate entity principle has many other implications not discussed here, such as the entity's ability to transfer property, to sue, and to be used.

FN21 Phillip I. Blumberg, Limited Liability and Corporate Groups, 11 J. CORP. L. 573, 587-91 (1986) (describing early American law providing for shareholder liability).

FN22 Id. at 591-95 (limited liability was the rule by the middle of the nineteenth century with several exceptions that continued into the twentieth century).

FN23 Easterbrook & Fischel, supra note 5, at 97 (limited liability increases funding availability for projects that have positive net values, but carry too much risk in terms of potential to wipe out all of the investor's capital).

FN24 Roger E. Meiners, James S. Mofsky, & Robert D. Tollison, Piercing the Veil of Limited Liability, 4 DEL. J. CORP. L. 351, 361 (1979) ("when an individual contracts to limit his liability or has it limited by law, market conditions force him to pay a price for limited liability").

FN25 Richard A. Posner, The Rights of Creditors of Affiliated Corporations, 43 U. CHI. L. REV. 499, 501-02 (1976) (creditors might be superior risk bearers because they are less risk averse or have superior information). But see Easterbrook & Fischel, supra note 5, at 91 (presumption that creditors are more risk averse is implausible; superior information can explain some, but not all, of limited liability). One example of a creditor who may be a more efficient risk evaluator is a seller of a business who extends credit to finance the sale. A seller taking back a note for a purchase price might be better able to evaluate whether the business can produce sufficient income to pay off the note than the purchaser would.

FN26 Blumberg, supra note 21, at 616-19 (limited liability fundamentally unfair to tort victims and other involuntary creditors and has undesirable consequences for labor claimants with severe informational disabilities and lack of ability to diversify and to absorb loss).

FN27 Henry G. Manne, Our Two Corporation Systems: Law and Economics, 53 VA. L. REV. 259, 262 (1967) (publicly held corporations with many small shareholders could not exist without limited liability).

FN28 Paul Halpern, Michael Trebilcock & Stuart Turnbull, An Economic Analysis of Limited Liability in Corporation Law, 30 U. TORONTO L.J. 117, 130-31 (1980); Susan E. Woodward, Limited Liability in the Theory of the Firm, 141 J. INSTITUTIONAL & THEORETICAL ECON. (ZEITSCHRIFT FUR DIE GESAMTE STAATSWISSENSCHAFT) 601, 604-05 (1985). Proportional liability has been suggested as a response to these market concerns. See HENRY HANSMANN & REINIER KRAAKMAN, THE UNEASY CASE FOR LIMITING SHAREHOLDER LIABILITY FOR CORPORATE TORTS (1990).

FN29 Cf. STEPHEN PRESSER, PIERCING THE CORPORATE VEIL 1-12 (1991) (arguing for a "democratic" justification for limited liability designed to encourage individual investment by those of moderate means as opposed to firms owned only by the wealthy).

FN30 See Markarian v. Califano, 473 F.Supp. 671 (W.D.N.Y. 1979) (Social Security Administration could not pierce

the veil of a close corporation to decrease a claimant's eligibility for benefits on the grounds that earnings were to be considered as coming from a sole proprietorship).

FN31 See Roccograndi Unemployment Compensation Case, 197 Pa. Super. 372, 178 A.2d 786 (1962) (holding shareholder/employees to be self-employed and ineligible for benefits where claimants had sufficient control to lay themselves off) (reported at 178 A.2d 786 (1962) as Roccograndi v. Unemployment Compensation Bd. of Review).

FN32 See Johnson & Higgins v. Comm'r of Ins., 321 So. 2d 281, 281-85 (Miss. 1975) (statute requiring disclosure of the shareholders of any company applying for an insurance license did not require disclosure of shareholders of such a company's parent). But see General Tel. Co. v. United States, 449 F.2d 846, 855 (5th Cir. 1971) (regulations that restrict activities of telephone common carriers apply to noncarrier subsidiaries of carrier parents).

FN33 United States v. Milwaukee Refrigerator Transit Co., 142 F. 247, 255 (C.C.E.D. Wis. 1905).

FN34 Henry W. Ballantine, Separate Entity of Parent and Subsidiary Corporations, 14 CALIF. L. REV. 12, 19 (1925).

FN35 MODEL BUSINESS CORP. ACT § 6.22(b) (1985).

FN36 See id. § 6.22 official comment. Section 7.32(f), a 1990 proposed amendment to the Model Act, would provide some legislative guidance on piercing the veil where shareholders of close corporations enter agreements to eliminate or restrict the power of the board or otherwise provide for less formal corporate governance. Action pursuant to such an agreement

shall not be a ground for imposing personal liability on any shareholder for the acts or debts of the corporation even if the agreement or its performance treats the corporation as if it were a partnership or results in failure to observe corporate formalities otherwise applicable to the matters governed by the agreement.

Changes in the Revised Model Business Corporation Act--Amendments Pertaining to Closely Held Corporations, 46 BUS. LAW. 297, 301 (1990). Similar laws already exist in several states. See CAL. CORP. CODE § 300(e) (West Supp. 1991); TEX. BUS. CORP. ANN. art. 12.37(f) (Vernon Supp. 1991); WIS. STAT. ANN. § 180.995(20) (West Supp. 1990). No effect of the statutes on judicial opinions is yet observable.

FN37 DEL. CODE ANN. tit. 8, § 162(b)(6) (1983).

FN38 TEX. BUS. CORP. ACT ANN. art. 2.21A(2) (Vernon Supp. 1991).

FN39 Id. art. 2.21A(3).

FN40 Castleberry v. Branscum, 721 S.W.2d 270, 273 (Tex. 1986) (to pierce a corporate veil, a plaintiff need only prove constructive fraud, which is "the breach of some legal or equitable duty which, irrespective of moral guilt, the law declares fraudulent because of its tendency to deceive others, to violate confidence, or to injure public interests").

FN41 See, e.g., 15 U.S.C. § 78t (1988) (liability of control persons). See generally PHILLIP I. BLUMBERG, THE LAW OF CORPORATE GROUPS: PROBLEMS OF PARENT AND SUBSIDIARY CORPORATIONS UNDER STATUTORY LAW OF GENERAL APPLICATION § 1.01 (1989), categorizing "specific" statutes and "general" statutes and describing how some statutes have been transformed from general statutes to specific statutes.

FN42 See PHILLIP I. BLUMBERG, supra note 41, § 1.01 nn. 6 & 7.

FN43 Congress has not defined insider trading, leaving the law to evolve on a case-by-case basis.

FN44 Although, there has been some movement to codify directors' fiduciary duty in the last 20 years. See MODEL BUSINESS CORP. ACT. § 8.30 (1985) (fiduciary duty remains judge-made law).

FN45 See I. MAURICE WORMSER, DISREGARD OF THE CORPORATE FICTION AND ALLIED

CORPORATION PROBLEMS 37-38 (1927) (suggesting that an effort at codification is "not only impossible but preposterous").

FN46 See, e.g., MODEL BUSINESS CORP. ACT § 6.40 (1985).

FN47 The search included the terms "piercing the corporate veil" and "disregard of corporate entity," and the appropriate Westlaw key numbers. For the precise search term, see supra note 1. The earliest date of the cases varied depending on the breadth of the various Westlaw libraries; there were almost no cases prior to 1930, and only a handful each year until the mid-1950s. See infra Table 2.

FN48 The data was collated from the cases by Rebecca Arnold, John Butrus, Cynthia Day, Paula Decker, Michael Mermal, Paul Rachlin, and Sherry Rozell, all now graduates of the Washington University School of Law.

FN49 The factual data gathered also included subordination as an alternative to the piercing/no piercing outcome. Eight subordination cases were found but because of the small number, they are not included in this analysis.

FN50 "Undercapitalization" was subdivided into those cases in which undercapitalization was present at the beginning of the corporation's life and those cases in which the corporation became undercapitalized later.

FN51 "Informalities" was subdivided into matters relating to meetings, records, or other informalities.

FN52 The "overlap" category separately tabulated overlap in meetings, directors, business activity, owners, management, bank accounts, hiring and firing decisions, books, contracts, insurance policies, advertising, corporate acts, officers, assets, records, tax returns, stationery, personalities, employees, tariffs, retirement plans and organizational charts. If a court listed two or more of these categories, each item was recorded.

FN53 This category included both misrepresentation as to the corporation's assets and financial condition, and misrepresentation as to the party responsible for payment. Courts sometimes use "fraud" language to describe these claims, but in most cases the misrepresentation is less than that required to recover under common-law fraud (or some codification of that rule of law). Indeed, if the plaintiff had a good fraud case, she would probably have pleaded it. See Krendl & Krendl, supra note 16, at 31 ("fraud [is] difficult to prove, and the quantum of evidence available in most corporate veil cases is considerably smaller than would be required to carry the burden on a fraud claim").

FN54 "Shareholder domination" includes such conduct as the shareholder paying corporate expenses or continuing losses, paying salaries of corporate employees or guaranteeing corporate debt, owning all of the stock of the corporation, treating the corporation as a department, or the corporation engaging in no independent action.

FN55 This category is closely related to shareholder domination. It provided a place to separately identify commingling of funds or siphoning of corporate funds, the shareholder treating corporate assets as its own, and other intertwining activities. A separate category was used to identify cases for which the court described the relationship between corporation and shareholder as an agency relationship.

FN56 A court's perception that a corporation is merely the "alter ego" of its shareholders is a common reason given for piercing the veil. It is frequently attacked by commentators for its conclusory nature. See, e.g., Latty, supra note 6, at 625; Note, supra note 6, at 1086.

FN57 Whether a corporation is nothing more than an "instrumentality" of its shareholders has long been used as a test for piercing the veil, see F. POWELL, supra note 7, at 8-9, but it too has received much abuse from commentators. See, e.g., Easterbrook & Fischel, supra note 5, at 109; Hackney & Benson, supra note 7, at 843 (instrumentality of too uncertain meaning to express any legal test).

FN58 Several commentators have said that the question comes down to fairness. See, e.g., supra text accompanying note 34. Courts, too, are sometimes satisfied with the reason. Courts include a general reference to equity, fairness, or justice as a reason for piercing in 135 cases in the data set.

FN59 The "assumption of risk" category was designed to capture those cases in which courts addressed specifically whether participants contracted with a corporation and thereby assumed the risk that the corporate assets would be insufficient to pay the debts.

FN60 Self-piercing cases use terminology similar to piercing cases, but the chances of a court allowing such piercing are much less. In self-piercing, the corporation asks the court to pierce the veil to entitle the enterprise to a benefit that would not be available if the corporation were considered separate from its shareholders.

FN61 "Statutory policy" could be derived from statutes, treaties, or foreign law. The "judicial reasoning" part of the form did not separately identify statutory policy, but the factual part of the survey form, asking for the context in which the case arose, identified the following types of statutes: tax, workers' compensation, unemployment compensation, social security, Medicare, antidiscrimination, garnishment, usury, antitrust, patent, maritime, securities, public utilities, corporate, condemnation, real property, foreign subsidiaries, labor, estates, divorce, ERISA, environmental, bankruptcy, and liquor regulation. Constitutional issues and general government regulation were also identified.

FN62 In an additional article in progress, I use this data and a logit analysis, a form of statistical regression analysis, to test the relationship between a dependent variable, here the court's decision to pierce the veil, and independent variables here the various factors recorded in the data set. Not surprisingly, the "conclusory" indicators of alter ego and instrumentality are the factors most closely associated with a piercing result. The explanation of that model and the results are left for another day.

FN63 A search of Lexis, as opposed to Westlaw, cases would produce a somewhat different universe, but probably not affect the results.

FN64 Posner, supra note 25, at 524.

FN65 George L. Priest & Benjamin Klein, The Selection of Disputes for Litigation, 13 J. LEGAL STUD. 1, 4 (1984) (developing a model that suggests "disputes selected for litigation (as opposed to settlement) will constitute neither a random nor a representative sample of the set of all disputes").

FN66 George L. Priest, Selective Characteristics of Litigation, 9 J. LEGAL STUD. 399 (1980); George L. Priest, Measuring Legal Change (1987) (Yale Law School working paper, Program in Civil Liability).

FN67 For example, defendants who thought that undercapitalization leads to veil piercing would be more inclined to settle those cases before trial.

FN68 See, e.g., sources cited supra notes 3-18.

FN69 The results are given in Tables 2, 3, and 4. Except in Table 4, the data is not broken down between trial and appellate courts. It is possible that there is an "affirmed" effect, a tendency of appellate courts to affirm the decisions of lower courts, which the data as presented here does not reveal. For a more general discussion of this possibility, see Theodore Eisenberg & Stewart J. Schwab, What Shapes Perceptions of the Federal Court System?, 56 U. CHI. L REV. 501, 517-19 (1989).

FN70 As set out in Table 7, infra, the data set included 777 close corporation cases, 637 parent/subsidiary or sibling cases, and nine cases involving public corporations. Two or more corporations controlled by the same person or entity are "sibling corporations."

FN71 In the nine public corporations cases included in the data set the court's decision was not to pierce. Professor Blumberg lists Anderson v. Abbott, 321 U.S. 349, reh'g denied, 321 U.S. 804 (1944), as a possible exception to the generalization that courts do not pierce the veils of publicly held corporations. Blumberg, supra note 15, at 289 n.11; cf. Fors v. Farrell, 271 Mich. 358, 260 N.W. 886 (1935) (similar result under a comparable Michigan statute). The Abbott Court held that shareholders of a bank holding company, who apparently numbered several thousand, were subject to the double liability imposed by federal statute on bank shareholders, even though the bank holding company

was the sole actual shareholder of the bank subject to the statute. The Court sought to prevent evasion of the double assessment provisions of the Banking Act. This case can be distinguished from many piercing cases because of the specific provisions of the Banking Act which impose double liability on all shareholders. Abbott does not necessarily support imposing liability on public shareholders in the absence of a statute. Banking law no longer imposes double liability, so it is appropriate to characterize this case as sui generis. Even so, Justice Douglas's broad language continues to be cited as justification for piercing the veils of close corporations and parent/subsidiary companies.

FN72 See supra text accompanying notes 24-26.

FN73 See Woodward, supra note 28, at 603 ("[l]imited liability [in publicly traded firms] can be motivated solely by transaction and information costs" without the consideration of risk aversion); see also Halpern, Trebilcock & Turnbull, supra note 28, at 130-31 (a capital market would exist for unlimited liability firms among wealthy investors, but there will not be a single price for all shares of a particular company).

FN74 See Easterbrook & Fischel, supra note 5, at 109-10 (the authors note that close corporations do not reap the other benefits of limited liability: facilitating efficient riskbearing, facilitating monitoring by capital markets, less need for facilitating the takeover market or diversification, and greater moral hazard problems).

FN75 For example, about two-thirds of the tort cases involve corporate shareholder defendants. The piercing rate for those cases is lower than for cases in the data set. See infra text accompanying notes 171-72.

FN76 Contra David H. Barber, Piercing the Corporate Veil, 17 WILLAMETTE L. REV. 371, 404 (1981) (courts moving slowly toward permitting piercing in more and more situations).

FN77 Table 2 shows results from each of the last three decades. The differences between decades in Table 2 are not statistically significant. The statistical significance refers to the degree of confidence we have in rejecting a particular null hypothesis. In this paper the null hypothesis is usually some variation of the hypothesis that there is no difference between piercing percentages from different groups of cases (e.g., those in different time periods or those involving corporations with different numbers of shareholders).
The significance level is the probability that a result as extreme as the one observed could have occurred by chance. If the observed significance level is small enough, usually 0.05, the null hypothesis is rejected.
AZ test is used to measure the difference. AZ value greater than 1.96 indicates that a result is significant at the 0.05 level. That is, in 95 times out of 100, the difference as set forth in the data would not have occurred by chance. That threshold is used in this paper for results described as statistically significant.

FN78 The difference is not statistically significant. These findings contradict earlier suggestions that federal courts are more willing to pierce the corporate veil. See Note, Piercing the Corporate Veil: The Alter Ego Doctrine Under Federal Common Law, 95 HARV. L. REV. 853, 870 (1982); see also Note, Piercing the Corporate Veil in Federal Courts: Is Circumvention of a Statute Enough?, 13 PAC. L.J. 1245, 1255 (1982) (authored by Patricia J. Hartman) (federal courts require a lesser burden of proof to disregard the corporate entity)

FN79 The differences are not statistically significant.

FN80 Government plaintiffs were not classified as either individual or corporate and had a piercing success rate of about 58%. See infra Table 8.

FN81 See infra Table 8. "Creditors" was used here to include those persons who had a bargain-type relationship with the corporation prior to the event that gave rise to the piercing claim. The differences in Table 8 between government as plaintiff and creditors as plaintiff and between corporations as plaintiff and creditors as plaintiff are statistically significant.

FN82 See infra Table 6. The results from the states with the largest numbers of piercing cases are as follows:

States	Cases	Percentage Pierced
New York	212	34.91
Texas	106	34.91
California	89	44.94
Illinois	78	42.31
Louisiana	67	35.82
Pennsylvania	65	30.77
Georgia	47	38.30
Florida	46	41.30

FN83 Again, "statistical significance" refers to the degree of confidence we have in rejecting a null hypothesis that the difference in the results could not have occurred by chance. See supra note 77. The Z test value for the difference between California and New York, for example, was 1.66.

FN84 Under the California constitution and implementing statutes between 1849 and 1931, shareholders had a pro rata liability for all corporate obligations incurred while they were shareholders. See 2 HAROLD MARSH, JR., MARSH'S CALIFORNIA CORPORATION LAW § 15.13 (2d ed. 1986).

FN85 CAL. CONST. art. IV, § 36 (1849) (repealed 1879); id. art. XII, § 3 (1879) (repealed 1930). An 1850 statute specified that each shareholder was liable only for the proportion of a claim that corresponded to the shareholder's proportional ownership of the corporation. Act of Apr. 22, 1850, ch. 128, § 32, 1850 Cal. Stat. 347, 350, amended by Act of Apr. 27, 1863, ch. 518, § 1, 1863 Cal. Stat. 766, repealed by Act of June 12, 1931, ch. 862, § 1, 1931 Cal. Stat. 1762. A 1929 statute authorized limited liability if "Limited" or "Ltd." was included in the corporate name. Act of May 23, 1929, ch. 418, § 1, 1929 Cal. Stat. 740. The constitutional provision providing for shareholder liability was repealed in 1930, and the implementing statute was repealed in 1931. Act of June 12, 1931, ch. 862, § 1, 1931 Cal. Stat. 1762.

FN86 2 H. MARSH, supra note 84, § 15.13 at 330.

FN87 New York cases made up 13.39% of the data set. The percentage of cases in which the courts pierced (34.91%) is less than the 40.1% for all cases, but this difference is not statistically significant. See supra note 77.

FN88 In the data set, there were 11 cases decided on the basis of Delaware law.

FN89 See supra text accompanying notes 70-74.

FN90 More than half of all corporations listed on the New York Stock Exchange are incorporated in Delaware, but Delaware cases make up less than 0.7% of the data set. The lack of Delaware cases illustrates the focus on close corporations evident in the piercing cases, and suggests that even for corporate groups, the issue occurs less frequently in the largest American corporations. Of the few Delaware cases, most relate to parent/subsidiary contexts. See, e.g., Pauley Petroleum, Inc. v. Continental Oil Co., 43 Del. Ch. 366, 231 A.2d 450 (1967), aff'd, 43 Del. Ch. 516, 239 A.2d 629 (1968); Buechner v. Farbenfabriken Bayer Aktiengesellschaft, 38 Del. Ch. 490, 154 A.2d 684 (1959).

FN91 The only other jurisdictions with a lower piercing percentage were New Hampshire (no piercing in five cases) and Puerto Rico (no piercing in three cases). There were no Vermont cases.

FN92 The jurisdiction of incorporation is chosen in the first instance by the incorporator and can be changed thereafter by the directors and the shareholders. Creditors have no direct influence on this choice.

FN93 The internal affairs rule refers to legal rules governing relations among shareholders, officers, and directors, which are the major topics of state corporations codes. See RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 309 (1969).

FN94 See, e.g., MODEL BUSINESS CORP. ACT § 15.05(c) (1984) ("This Act does not authorize this state to regulate the organization or internal affairs of a foreign corporation authorized to transact business in this state.").

FN95 See, e.g., CAL. CORP. CODE § 2115 (West 1991) (requiring corporations with certain minimum contacts to comply with several California provisions protecting shareholders: cumulative voting, inspection, and dissenters' rights); N.Y. BUS. CORP. LAW § 1317 (McKinney 1991). The constitutionality of these statutes has not been resolved. Compare Wilson v. Louisiana-Pacific Resources Inc., 138 Cal. App. 3d 216, 187 Cal. Rptr. 852 (1982) (upholding imposition of a California cumulative voting provision on a Utah corporation doing business in California) with Arden-Mayfair, Inc. v. Louart Corp., 385 A.2d 3 (Del. Ch. 1978) (holding the California statute inapplicable under generally recognized choice of law principles).

FN96 A Texas statute, enacted in 1989 after the Castleberry case, discussed supra note 40, states that the laws of the jurisdiction of incorporation of a foreign corporation shall govern internal affairs and "the liability, if any, of shareholders of the foreign corporation for the debts, liabilities and obligations of the foreign corporation for which they are not otherwise liable by statute or agreement." TEX. BUS. CORP. ACT ANN. art. 8.02 (Vernon 1991).

FN97 RESTATEMENT (SECOND) OF THE CONFLICT OF LAWS § 307 (1969) ("The local law of the state of incorporation will be applied to determine the existence and extent of a shareholder's liability to the corporation for assessments or contributions and to its creditors for corporate debts.") The comment to section 307 refers to exceptions for actions deemed "penal or . . . contrary to a strong local public policy." Id. comment e at 329; see also TEX. BUS CORP. ACT ANN. art. 8.02 (Vernon 1991) (discussed supra note 96).

FN98 See Joncas v. Krueger, 61 Wis. 2d 529, 535, 213 N.W.2d 1, 4 (1973) (Wisconsin statute imposing personal liability on corporate shareholders for unpaid wages due to corporation's employees is applicable to foreign corporations. "We see no valid distinction . . . why Wisconsin employees working in Wisconsin should be classified for benefits depending upon where their employer is incorporated."). But see Armstrong v. Dyer, 268 N.Y. 671, 198 N.E. 551 (1935) (under similar New York statute, shareholders of a foreign corporation are not liable).

FN99 See, e.g., Japan Petroleum Co. (Nigeria) v. Ashland Oil, Inc., 456 F.Supp. 831, 840 n.17 (D. Del. 1978) (most standards are essentially the same despite slight variations).

FN100 The Z test value for single shareholders versus close corporations with more than three shareholders is 3.44. The Z test value for two or three person corporations versus larger close corporations is 2.50.

FN101 Salomon v. A. Salomon & Co., 1897 App. Cas. 22 (1896) (shares held in the name of a leather merchant, his wife, and five children; after the company became insolvent, the House of Lords rejected the creditor's claim that the corporation was a sham).

FN102 See, e.g., Bernard F. Cataldo, Limited Liability with One-Man Companies and Subsidiary Corporations, 18 LAW & CONTEMP. PROBS. 473, 475 (1953); Warner Fuller, The Incorporated Individual: A Study of the One-Man Company, 51 HARV. L. REV. 1373, 1405 (1938); Note, supra note 6, at 1089 (peculiar opportunity for manipulation and superior knowledge of sole shareholder make it desirable that a sole shareholder claiming limited liability affirmatively show that corporation is adequately financed).

FN103 Salomon, 1897 App. Cas. at 44-45.

FN104 See, e.g., Note, Corporations--Shareholder Liability--Louisiana Adopts a Balancing Test for Piercing the

Corporate Veil, 58 TUL.L.REV. 1089, 1100 (1984) (authored by Patricia A. Carteaux) (language in early cases seems to render retention of limited liability in a one man corporation nearly impossible).

FN105 For example, many of the overlap factors are inevitable in a one person corporation.

FN106 When the targets of piercing were described as shareholders, courts pierced in 41.51% of the cases (203 of 489). When the targets of piercing were described as both shareholders and officers or directors, the percentage of piercing cases moved to 46.36% (140 of 302).

FN107 Courts refused to pierce in five of the six cases in the data set that were directed at passive shareholders.

FN108 When potential targets of piercing were individuals, courts pierced in 43.13% of the cases (339 of 786). Piercing was the outcome in 37.21% of cases where the target was another corporation (237 of 637). See supra Table 7

FN109 Easterbrook & Fischel, supra note 5, at 110-11; Krendl & Krendl, supra note 16, at 42 (parent-subsidiary relationship will be more closely scrutinized and may be more readily susceptible to veil-piercing than corporations with individual shareholders). But see Note, Inadequately Capitalized Subsidiaries, 19 U. CHI. L. REV. 872 n. 1 (1952) (in the case of corporations with inadequate capitalization, "liability appears to be more frequently limited when the stockholder is not a corporate entity").

FN110 See supra Table 7 for the data on one shareholder and two or three shareholder corporations. The percentage for remaining close corporations, 34.98% (92 of 263 cases), is less than the 37.21% piercing result where the shareholders are corporations. This difference is not statistically significant.

FN111 See supra Table 7. When the piercing was directed through a parent to get at a subsidiary, courts pierced in only 19 of 68 cases (27.94%). In the more common case where litigants sought to reach through the subsidiary to get to the parent, the courts pierced in 142 of 386 cases (36.79%), still a lower rate than in the sibling situation (41.53%).

FN112 See the results described in Table 7 supra.

FN113 See the results described in Table 5 supra.

FN114 The Z test value for the government as plaintiff compared to creditors as plaintiff is 4.12. The Z test value for the corporation as plaintiff as compared to creditors as plaintiffs is 6.83. For an explanation of Z values, see supra note 77.

FN115 See note, Reverse Piercing the Corporate Veil: Should Corporation Owners Have It Both Ways, 30 WM. & MARY L. REV. 667, 668 (1989) (authored by Michael J. Gaertner).

FN116 The Z test value is 2.98. A contract situation was defined to include piercing cases arising out of bargain situations in which the plaintiff entered into an individual transaction with the corporation.

FN117 For voluntary contact, courts pierced in 479 of 1142 cases (41.94%). For cases with no voluntary contact, courts pierced in 133 of 379 cases (35.09%). These results include more cases than the contract and tort categories in Table 9 because the voluntary/involuntary categories picked up cases that arose out of various statutory contexts. Some of these cases arose from voluntary transactions between the parties (e.g., a bankruptcy setting in which a creditor is seeking to pierce the veil) and some arose from situations in which the parties had no voluntary contact (e.g., criminal law or other regulatory law).

FN118 They also are counter to Alexander Frey's early study on individual liability for defective incorporation. That study found greater liability for individuals in situations where the plaintiff had not dealt with the entity as a corporation than those cases in which the dealings were on a corporate basis. Alexander Hamilton Frey, Legal Analysis and the "De Facto" Doctrine, 100 U. PA. L. REV. 1153, 1174 (1952).

FN119 See, e.g., Krendl & Krendl, supra note 16, at 34; Landers, supra note 4, at 623 (creditors better able to protect themselves). This distinction between contract and tort creditors is not recent. See William O. Douglas & Carrol M. Shanks, Insulation from Liability Through Subsidiary Corporations, 39 YALE L.J. 193, 210-11 (1929) (noticing difference between contract and tort settings).

FN120 Easterbrook & Fischel, supra note 5, at 112 (rationale for greater willingness to pierce in torts than contracts follows directly from the economics of moral hazard; where corporations don't have to pay for the risk, they are more likely to engage in activities where social costs exceed social benefit).
Other commentators have noted that results did not seem to fit with theory. See Barber, supra note 76, at 381 (one might expect different treatment for contract and tort but most courts mechanically apply the same test to both situations); G. Michael Epperson & Joan M. Canny, The Capital Shareholder's Ultimate Calamity: Pierced Corporate Veils and Shareholder Liability in the District of Columbia, Maryland, and Virginia, 37 CATH. U.L. REV. 605, 633 (1988) (despite extensive scholarship on this point, most courts have failed to distinguish between tort and contract); Hamilton, supra note 6, at 984-85, (astonishing to find that this fundamental distinction is only dimly perceived by many courts).

FN121 Misrepresentation in this context refers to conduct that usually is something less than would be required to recover under the common-law action of deceit. See supra note 53. For purposes of this study, misrepresentations that occurred in a bargain relationship were included in the contract category, since the primary purpose of the contract/tort division was to distinguish those transactions in which the parties had a preexisting relationship from those in which they did not.

FN122 267 U.S. 333 (1925). Professor Blumberg suggests: "The star of Cannon is unmistakably on the wane." P. BLUMBERG, supra note 3, at 47.

FN123 56 Cal. 2d 823, 366 P.2d 502, 17 Cal. Rptr. 150 (1961).

FN124 Douglas & Shanks, supra note 119, at 204.

FN125 P. BLUMBERG, supra note 3, at 461.

FN126 Id.

FN127 See Comprehensive Sports Planning, Inc. v. Pleasant Valley Country Club, 73 Misc. 2d 477, 341 N.Y.S.2d 914 (N.Y. Civ. Ct. 1973) (standard for piercing varies with purpose, and standard for establishing jurisdiction is less strict than standard for finding shareholder liability); cf Charles I. Wellborn, Subsidiary Corporations in New York: When is Mere Ownership Enough to Establish Jurisdiction Over the Parent, 22 BUFFALO L. REV. 681, 685-87 (1973) (limited liability and limited amenability are coexistent).

FN128 Courts pierced in 224 of 552 cases (40.58%). The different statutory categories are listed infra note 135.

FN129 When the dispute was based on tax law (federal, state, income, estate, etc.), courts pierced in 41 of 133 cases (30.83%). See infra note 135.

FN130 Of course, there are ways to avoid double taxation, such as electing subchapter S status or zeroing out corporate income.

FN131 Courts pierced in only 5 of 39 cases (12.82%) involving workers' compensation. See infra note 135.

FN132 In effect, corporate defendants claim a form of self-piercing, asking the trier of fact to consider the corporation and its shareholder as one employer, which blocks the civil claim against both. See PHILIP I. BLUMBERG, THE LAW OF CORPORATE GROUPS SUBSTANTIVE LAW 327-38 (1987).

FN133 The failure to pierce is probably encouraged by the general judicial reluctance to let corporations argue self-

piercing. See, e.g., Boggs v. Blue Diamond Coal, 590 F.2d 655 (6th Cir.), cert. denied 444 U.S. 836 (1979).

FN134 This conclusion is muted because there are only a few cases in the data set (six). Some environmental laws make corporate participants personally liable for actions they take or fail to take on behalf of the corporation. See, e.g., Comprehensive Environmental Response Compensation and Liability Act of 1980 (CERCLA), 42 U.S.C. §§ 9601-9675 (1988), which imposes liability on owners or operators of certain polluting facilities. In light of this statutory policy, it is not surprising to see a higher piercing percentage in environmental cases.

FN135 The results for cases broken down by statutory context are:

Context	Piercing/No-Piercing	%
ERISA	2/0	100.00
Environment	5/1	83.33
Fraud	9/2	81.82
Patent	14/5	73.68
Discrimination	5/2	71.43
Antitrust	10/6	62.50
Securities	4/3	57.14
Estate	8/6	57.14
Medicare	4/3	57.14
Public Utilities	6/5	54.55
Labor	16/14	53.33
Govt. Regulation	21/19	52.50
Liquor	3/3	50.00
Bankruptcy	16/18	47.06
Divorce	12/14	46.15
Usury	8/10	44.44
Unemployment	9/13	40.91
Maritime	4/6	40.00
Garnishment	2/4	33.33
Tax	41/92	30.83
Other	6/15	28.57
Corporate	7/18	28.00

Social Security	1/3	25.00
Real Property	3/12	20.00
Foreign Subsidiary	1/4	20.00
Condemnation	2/10	16.67
Workers Comp.	5/34	12.82
FELA	0/4	0
Constitution	0/2	0

FN136 Undercapitalization was present in 61 of the 327 contract cases in which the court pierced the veil (18.65%). Courts cited undercapitalization in only 18 of the 224 statutory cases in which they pierced (8.04%).

FN137 Informalities were cited in 67 of 327 contract cases in which the court pierced (20.49%) as compared to 25 of 224 statutory cases (11.16%). Misrepresentation was cited in 98 of the 327 contract cases (29.97%) and 39 of the 224 statutory cases (17.41%).

FN138 Comment, Disregarding the Corporate Entity: Contract Claims, 28 OHIO ST. L.J. 441, 441 (1967).

FN139 These categories are indirectly characterized supra notes 50 and 51.

FN140 Since the piercing tests used by courts tend to include many factors, courts often mention factors that lead to piercing which are not present in a particular case. The factors tabulated are the same ones listed infra note 141.

FN141 The total number of cases in which the absence of a particular factor was noted by the court and the outcome of those cases are:

Absent Factor Mentioned	Pierce/No Pierce	Percentage Not Pierced
Misrepresentation	30/361	92.33
Overlap (all factors)	24/285	92.23
Alter Ego	1/165	99.40
Domination & Control	2/124	98.41
Lack of Substantive Separation	1/99	99.00
Informalities	4/71	94.67
Misuse of Corporate Purpose	4/67	94.37
Dummy	0/64	100
Instrumentality	0/59	100
Agency	1/53	98.15

Undercapitalization	3/48	94.12

FN142 Misrepresentation was noted as present in 169 cases. When courts mentioned the absence of misrepresentation in 391 cases, they went on to pierce in only 30. When courts observed the presence of misrepresentation, they went on to pierce just over 94% of the time (159 of 169 cases). See supra Table 11.

FN143 Courts mentioned the absence of overlap between corporation and shareholders in 309 cases and pierced in 24. Courts observed the presence of overlap in 822 cases, and pierced in 469 (57.06%). See supra Table 11.

FN144 HENRY WINTHROP BALLANTINE, BALLANTINE ON CORPORATIONS 303 (rev. ed. 1946).

FN145 Berle, supra note 12, at 349 n.15 ("In all cases insufficient capitalization is persuasive evidence that the enterprise was not separate").

FN146 Rutheford B. Campbell, Limited Liability For Corporate Shareholders: Myth Or Matter-Of-Fact, 63 KY. L.J. 23, 53 (1975).

FN147 Berle, supra note 12, at 352-53; Hamilton, supra note 6, at 988; Note, Inadequate Capitalization As A Basis For Shareholder Liability: The California Approach And A Recommendation, 45 S. CAL. L. REV. 823, 836 (1972) (authored by Robert E. Dye).

FN148 Hackney & Benson, supra note 7, at 865 ("[A]ny element of misrepresentation, express or implied, coupled with undercapitalization, will warrant imposition of . . . liability").

FN149 Undercapitalization was present in 12 torts cases; in nine, courts pierced the veil (75.00%). Undercapitalization was present in 87 contracts cases; in 61, courts pierced the veil (70.11%). The difference is not statistically significant.

FN150 Piercing occurred in 18 of 22 cases.

FN151 See the results described supra text accompanying note 149.

FN152 See infra note 154.

FN153 See id.

FN154 When piercing the veil, courts cited undercapitalization as follows:

Number of Shareholders	Number of Cases When Court Pierced	Number of Piercing Cases Citing Undercap	Percentage of Piercing Cases that Cited Undercap
One	137	20	14.60
Two or Three	110	27	24.55
Close	92	11	11.96

Parent/Sub	162	18	11.11
Sibling	76	8	10.53

FN155 See supra Table 11.

FN156 Id.

FN157 E.g., Krendl & Krendl, supra note 16, at 28 n.98 (noting that most states do not penalize a corporation for non-compliance with procedural formalities, and further noting that while a failure to follow formalities may indicate that the corporation is an instrumentality and may be misleading, the misrepresentation issue adequately addresses these concerns).

FN158 Barber, supra note 76, at 377; Campbell, supra note 146, at 45; Epperson & Canny, supra note 120, at 641.

FN159 See results described supra Table 11

FN160 See the results described supra note 137. Informalities were present in 8 of the 70 (11.43%) tort cases in which courts pierced the veil.

FN161 See the results described supra note 136. Undercapitalization was present in 9 of the 70 tort cases in which the court pierced (12.86%).

FN162 Of 109 contract cases where informalities were present, the courts pierced in 67 (61.47%). Of 15 tort cases with informalities, the courts pierced in 8 (53.33%). Of 62 statutory cases involving informalities, the courts pierced in 25 (40.32%). The comparable results for undercapitalization are found supra text accompanying notes 149 and 151.

FN163 See Krendl & Krendl, supra note 16, at 31-34.

FN164 See supra text accompanying notes 118-20

FN165 Easterbrook & Fischel, supra note 5, at 112.

FN166 See supra Table 9. Some commentators have noted the lower percentages for piercing in the tort context. See Epperson & Canny, supra note 120, at 633 (despite extensive scholarship that tort plaintiffs should be preferred, the consistent outcome in Maryland and the District of Columbia has been to prefer the contract plaintiff more than the tort plaintiff).

FN167 Robert Charles Clark, The Duties of the Corporate Debtor to Its Creditors, 90 HARV. L. REV. 505, 542 n.98 (1977).

FN168 Misrepresentation can be treated as a tort. Although, in the piercing area, the misrepresentation referred to by courts does not rise to the level required for the traditional tort of deceit. See supra note 121. In this study, the contract category included transactions arising from a bargain setting; not surprisingly, almost all misrepresentation cases occurred in this setting.

FN169 In the contracts area, courts pierced in 327 of 779 cases (41.98%). See supra Table 9. Misrepresentation was cited by the court in 107 of those cases (98 in which the court pierced and 9 in which the court did not pierce). If those misrepresentation cases are subtracted from the contract group, the court pierced in 229 of 672 cases (34.08%), a percentage still higher than that of the tort results when misrepresentation cases are omitted (58 of 213) (27.23%).

FN170 See authorities cited supra note 147.

FN171 For tort cases, 149 of 205 (72.68%) involved corporations as targeted shareholders and 56 involved individuals (27.32%). The corporate/individual identity was not determined in the remaining 21 tort cases. In the overall set, excluding cases in which the corporate status of the defendant was not determined, 45% of the cases were directed at corporate defendants and 55% were targeted at individuals.

FN172 See authorities cited supra notes 119 and 120.

FN173 See Priest & Klein, supra note 65, at 40.

FN174 Cf. James A. Henderson & Theodore Eisenberg, The Quiet Revolution in Products Liability: An Empirical Study of Legal Change, 37 UCLA L. REV. 479, 483-85 (1990)(noting that the fall of the citadel of privity in the 1960s was followed by the fall of other barriers to recovery such as the patent danger rule and the bystander rule as courts extended the boundaries of products liability, and concluding that plaintiffs challenging traditional barriers "met with enough success to create the reasonable expectation that it was just a matter of time before those citadels fell in turn.").

FN175 This law is summarized in P. BLUMBERG, supra note 41, at 396-99.

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STATEMENT OF

EMORY W. RUSHTON

DEPUTY COMPTROLLER OF THE CURRENCY FOR MULTINATIONAL BANKING

before the

SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS

of the

COMMITTEE ON ENERGY AND COMMERCE

UNITED STATES HOUSE OF REPRESENTATIVES

February 3, 1988

Mr. Chairman and members of the Subcommittee:

I am pleased to appear before the Subcommittee today strictly as a technical witness to discuss Continental Illinois National Bank and Trust Company of Chicago (Continental Bank) and its subsidiary, First Options of Chicago, Inc. (First Options). In my capacity as the Deputy Comptroller for Multinational Banking, I am responsible for the supervision and financial analysis of the largest national banks, including Continental Bank.

As requested in the Subcommittee's letter of invitation, I will cover the following: (1) conversations I had with Continental Bank officials during the week of October 19, 1987; (2) the position of the Office of the Comptroller of the Currency (the Comptroller's Office) on the initial purchase of First Options by Continental Bank; (3) the efforts of the Comptroller's Office to monitor the terms of the purchase; and (4) the actions taken by the Comptroller's Office to assure that future capital infusions conform to the restrictions we placed on Continental Bank as a condition of approving the purchase.

First, I will address the bank's initial purchase of First Options, and will turn then to the other questions in the Chairman's letter.

Initial Purchase of First Options

The Comptroller's Office approved Continental Bank's proposal to purchase First Options, and operate it as a subsidiary, in December 1986. The approval came only after the Office had thoroughly reviewed the legal questions and the risks involved. Our approval covered activities that were legally permissible for a national bank to engage in directly. These primarily included extending credit, and performing transactional execution and clearing services. The Office was also satisfied that Continental Bank would have adequate controls over the possible risk associated with its ownership of First Options. Among the factors considered in reaching this determination were First Options' own internal control systems and the talent and experience of senior management of First Options.

The Comptroller's Office and the FDIC, which is Continental's largest shareholder, viewed the acquisition not only as a legitimate business for an operating subsidiary of a national bank, but as an opportunity to enhance the institution's earnings and market value, and thereby enhance the government's ability to return the bank to private ownership as quickly as possible.

The Federal Reserve Board also participated to the extent that it approved Continental's acquisition of First Options' London operation, which came under its jurisdiction.

Under existing law and regulations, there was no limit on the amount of financial support that Continental Bank could have given First Options as an operating subsidiary of the bank. However, due primarily to the significant size and importance of First Options in its industry, the Comptroller's Office, as a precautionary move, imposed certain restrictions on the financial relationship between First Options and the bank as a condition of the approval to acquire First Options. These restrictions included a limit on the bank's total investment in, and loans to, First Options to an amount that would not exceed what the bank could lend legally to an unaffiliated customer, as opposed to the unlimited amount it could lend legally to an operating subsidiary. As a standard rule of law, a national bank such as Continental could lend an amount equal to 15% of its capital to any borrower on an unsecured basis, plus an additional 10% of its capital, if the additional 10% was fully secured by readily marketable collateral. Because of the inclusion of these restrictions, the Comptroller's Office believed that the bank would be adequately insulated in the event First Options should suffer extraordinary financial losses.

Specifically, this meant that during the week of October 19, 1987, Continental Bank could invest in, or lend to First Options on an unsecured basis, approximately $381 million, plus an additional amount of about $254 million, if that additional amount were properly secured. Prior to that week, the bank had remained within the limits. It was the unsecured limit that the bank exceeded during the week of October 19, 1987. It was also this issue that prompted numerous telephone conversations between bank

officials and representatives of the Comptroller's Office, including myself, and that led to our taking formal enforcement action against the bank the following Monday, October 26, 1987.

Conversations During the Week of October 19, 1987

My first telephone discussion with Continental Bank officials following the market collapse on Monday, October 19, 1987, occurred at about 9:30 p.m. Eastern Time that evening when I returned a call to Continental's Executive Vice President Bill Gunlicks, at his home. (Mr. Gunlicks was the Continental Bank officer to whom First Options reported.) Shortly before that, I had received a call at my home from one of our field examiners who said that he also had been called by Mr. Gunlicks that evening, and that he had referred Mr. Gunlicks to me.

Mr. Gunlicks began the conversation by saying that First Options had remained in business during the day, and that the bank had stayed within, but was approaching, the unsecured lending and investment limits that were contained in our original approval. He described the day's trading activity as chaotic, and said that there were serious back-logs in pricing positions. He said that attempts would resume at 4:00 a.m. the next morning to determine the amount of losses resulting from customers who could not meet their obligations to First Options, which he estimated at possibly $30-$50 million. He also indicated that he would not know until the next day the amount of additional capital requirements that would be required of First Options. I told Mr. Gunlicks to keep us informed as more information became available.

The next morning, Tuesday, October 20, I began alerting other senior officials of the Comptroller's Office that a potential problem was developing at First Options that might require our involvement. Various senior members of our office were present during most of the conversations I had with bank officials the remainder of the day.

Early that afternoon, I received another call from Mr. Gunlicks. He advised me that independent vendors who priced securities were still behind schedule due to the heavy volume on the previous day, and that First Options' staff had been trying to establish prices manually since early that morning. He said the prices ultimately would affect First Options' capital requirements, and that he expected First Options would need additional capital that day. I told Mr. Gunlicks that we were not prepared to waive or increase the limits contained in our original approval. Mr. Gunlicks sounded as if he were under a great deal of pressure and was inconclusive as to what the bank might do if there actually turned out to be a capital shortfall at First Options that day.

Following that conversation, I discussed the matter with various senior officials of the Comptroller's Office, who agreed that we should not waive or increase the limit. We also agreed that we should caution other officials of the bank that our limits must not be exceeded, in light of Mr. Gunlicks' unclear position.

I then called Continental's General Counsel, and advised him that we were disturbed about the situation as Mr. Gunlicks had described it. I told the bank's General Counsel that the bank must not exceed the limits, and that any additional capital required by First Options should be obtained from other sources, including, if necessary, the bank's holding company, Continental Illinois Corporation. He professed a lack of knowledge of the subject, but promised to inquire immediately and call me back.

The bank's General Counsel called me back at about 4:00 p.m. Eastern Time, and said he had found out that there might not be a problem after all, because the bank believed it was appropriate to revise the method used to calculate the limits on the bank's investment in, and loans to First Options. He did not seem entirely clear about the revised calculations, but indicated that they involved a change in the way the bank had been viewing its equity investment in First Options. He said he understood that Mr. Gunlicks, along with our on-site examiner, would be calling me shortly thereafter to discuss the matter further. At that point in the day, we still had not been provided with any real or estimated amounts of additional capital that First Options might need.

I then called our on-site examiner who said that earlier in the day, he had personally rejected the bank's proposal to revise its calculations, and had so informed Mr. Gunlicks. According to the examiner, the bank's revised calculations were based simply on the notion that the bank's limit to First Options should be a total of 25% of the bank's capital, i.e., 15% unsecured, plus an extra 10% secured, regardless of whether there was proper collateral for the extra 10%. Under such a theory, which we rejected, the bank could have made unsecured loans to First Options, without regard to whether the total unsecured loans and investment exceeded the 15% unsecured limit. I told the examiner that senior management of the Comptroller's Office agreed with his rejection of the bank's revised calculations, and that he should likewise inform bank management of this fact. The examiner later told me that he had then informed Mr. Gunlicks, at about 3:30 p.m. Chicago Time, one-half hour before settlements for that day would be required, that his (the examiner's) original position had since been confirmed with the Washington Office.

Shortly after 5:00 p.m. Eastern Time, I received a joint call from Mr. Gunlicks and our on-site examiner. Mr. Gunlicks began the conversation by describing the general chaos of the past two days, and the need for additional capital support to First Options. He attempted to advance the revised calculation theory which I just described. I told Mr. Gunlicks that a national bank's legal lending limit, on which our original approval was conditioned, was 15% of the bank's capital, and that the additional 10% limit was available <u>only if it was fully secured by readily marketable collateral</u>, which the bank's investment in First Options was <u>not</u>.

At about this point in the conversation, Mr. Gunlicks' description of events changed from the present tense to the past tense, when he said for the first time that the bank had, within the last half-hour, already made an additional, unsecured advance of about $130 million to enable First Options to meet its estimated capital requirements. This advance, when combined with the bank's unsecured advances already outstanding, plus the unsecured equity investment, exceeded the unsecured limit by about $128 million. Apparently, the decision to make the extra advance was reached shortly after the examiner had informed Mr. Gunlicks that it was the official position of the Comptroller's Office that the bank's theory was not acceptable. Mr. Gunlicks told me that the decision to make the additional advance had been a "reasoned business decision" based on the exigencies of the moment, and that it had been approved by senior management of Continental.

I told Mr. Gunlicks that we considered the $130 million advance to be a violation of the limits imposed in our original approval, and that the bank must not make any further advances which would aggravate the situation. I also told him that we would have to consider appropriate remedial action and that we would be back in touch with them shortly.

Following that conversation, we prepared enforcement documents which would force immediate correction of the violation in the event that the bank refused to do so.

Later that evening, I received a call from the bank's General Counsel informing me that, upon the advice of their outside counsel, the bank's loan to First Options that exceeded the limit would be corrected the next morning by a direct loan to First Options from the bank's holding company.

I recommended that the Federal Reserve Board be informed of this plan, as the Federal Reserve is the primary regulator of the holding company. Shortly after that conversation, I spoke with a senior official of the Federal Reserve Board in Washington D.C. to describe what had happened, and to alert them that Continental probably would be calling them regarding the holding company advancing money to First Options.

The next morning, the bank's General Counsel called me to confirm that the bank's excessive loan to First Options had been repaid by a loan from the holding company. He also indicated that they would be discussing the matter with the Federal Reserve Board that morning.

Subsequent Events

Notwithstanding the bank's quick action to remedy the violation, the Comptroller's Office considered it necessary and appropriate to take formal enforcement action against Continental to ensure that in the future the bank observed the restrictions contained in our original approval.

Therefore, on the following Monday, October 26, 1987, representatives of the Comptroller's Office attended a meeting of Continental's Board of Directors in Chicago and described to them the seriousness of the violation that had occurred. At that meeting, each Director signed and agreed to the entry of a formal corrective Order.

With this Order in place, any further violation of the terms and conditions of the original approval can be immediately enforced in a federal district court. Further, as a result of having this Order in place, civil money penalties can be assessed against the bank and its directors for any violation of the Order. The Order also requires the development of a formal contingency plan, acceptable to the Comptroller, designed to avoid a repeat of the funding problem experienced during the week of October 19, 1987.

Since the bank's acquisition of First Options slightly more that a year ago, the Comptroller's Office has been monitoring compliance with the terms of the original approval through on-site examinations and other communications with bank management - and we will continue to do so.

Finally, we believe there are practical solutions that can be applied if, in the future, First Options should need additional capital support in excess of the limits in the original approval. For example, recently the bank requested our permission to increase its equity investment in First Options to enable First Options to meet certain equity requirements of the SEC and the exchanges. We did not approve that request because we were not prepared to let the bank increase its equity investment in First Options. As an alternative, we suggested that the bank's parent holding company could contribute the new equity either directly to First Options, or indirectly to First Options through the bank. This was accomplished several weeks ago. It illustrates one way that the Continental organization can support First Options without increasing the net exposure to the bank's capital and deposits.

Mr. Chairman, this concludes my prepared remarks. As agreed, I will be happy to respond to any technical questions you or the other members may have.

THE OCC'S PRIMARY CONCERNS ABOUT H.R. 10

"The Financial Services Act of 1999"
Introduced January 6, 1999

February 12, 1999

Table of Contents

1. DISPARAGEMENT OF THE NATIONAL BANK CHARTER

As discussed in greater detail below, provisions throughout H.R. 10 uniquely disadvantage national banks. The cumulative effect of these provisions is to undermine significantly the national bank charter, which is held by the preponderance of the nation's large and internationally active banks, hundreds of regional banks, and by more than 2,500 community banks. A basic principle of financial modernization legislation should be to ensure that new laws do not interfere with the free operation of financial markets, except to the extent necessary to protect fundamental and clearly defined governmental interests, such as safety and soundness and safeguarding the interests of consumers. Contrary to this basic principle, including safety and soundness, under H.R. 10, national banks would be subject to artificial, unnecessary, and costly restrictions that deprive them of the benefits of increased earnings and product diversification that the bill is intended to promote.

Specific Concerns:

- *National banks are deprived of flexibility in structuring their business operations*: Under Section 121, national banks are generally not permitted to use subsidiaries to offer expanded products as principal. Yet, foreign banks are permitted to have direct subsidiaries in the United States that engage in a full range of new financial activities, including underwriting securities. Nearly 40% of the so-called "Section 20 affiliates" permitted to underwrite and deal in bank impermissible securities in the United States today are, in fact, subsidiaries of foreign banks.

- *National bank subsidiaries offering products as an agent are subject to burdensome statutory requirements that are not imposed on state banks*: Section 121 applies restrictions to national banks conducting new agency activities through subsidiaries that are not applied to other depository institutions engaged in the same activities through subsidiaries.

- *The Barnett case is undercut*: The Supreme Court's decision in *Barnett Bank v. Nelson* is overturned and replaced with the new preemption standards in Section 104. That decision relied on preemption principles well-recognized by the courts and found that certain state insurance sales restrictions were preempted for national banks. The new preemption standards in H.R. 10 will permit states to discriminate against banks and their subsidiaries and affiliates in the sales of insurance. The new, complex, confusing and untested preemption standards will generate needless litigation and represent a step back from current law.

- *National banks continue to be subject to the "place of 5,000" rule in selling insurance*: No such restriction is applied to state banks. In fact, many states permit their banks to sell insurance anywhere.

- *OCC deference is eliminated for insurance*: The Supreme Court has consistently held that Federal agencies should be given deference for reasonable interpretations of the laws they administer. This long-standing and well established principle is eliminated under Section 306(e) for OCC determinations relating to national bank insurance activities. As a result, national banks will not be able to rely on OCC decisions and will be faced with increased business uncertainty and litigation risks.

- *National banks lose the authority to conduct safe and sound activities that are permissible today*: Banks and their subsidiaries cannot offer new insurance products as principal after January 1, 1997. Offering annuities as principal is flatly prohibited. National banks' title insurance underwriting is severely restricted. Many currently permissible securities activities, such as certain asset-backed securities transactions, are pushed out of the bank and into an affiliate.

- *National banks are subject to increased regulatory burdens*: The bill gives the Federal Reserve Board (rather than the OCC in the case of national banks) the authority to determine whether a bank is well capitalized if the bank is part of a bank holding company engaging in the new financial activities. The Board also has the authority under certain conditions to impose other restrictions on national banks, e.g., restrictions on transactions with nonbank affiliates (except subsidiaries of the bank). This subjects national banks to two different Federal regulators implementing Federal capital and operational standards.

2. SUBSIDIARIES OF BANKS

Section 103 permits bank holding company affiliates to engage in a broad range of financial activities, including securities and insurance underwriting. However, under Section 121, national bank operating subsidiaries may engage "solely as agent" in new financial activities that are impermissible for the parent bank to conduct directly, and even then, may do so only through wholly owned subsidiaries. Subsidiaries of national and state banks, as well as subsidiaries of thrifts, are expressly prohibited from engaging in new securities underwriting activities after September 15, 1997. Moreover, Section 304 prohibits national (and state) banks and their subsidiaries from producing any new insurance products after January 1, 1997. Foreign banks are NOT subject to these prohibitions and, under the bill, may have direct subsidiaries in the United States that engage in securities and insurance underwriting activities, as well as all other financial activities.

In addition, Section 121 subjects transactions between a national bank and its subsidiary engaging in the new agency activities--but not transactions between state banks or thrifts and their subsidiaries engaged in the same activities--to the operational requirements in section 23B of the Federal Reserve Act. Further, the new agency activities may be conducted in a subsidiary of a national bank only if all of its depository institution affiliates are well capitalized and well managed and satisfy other requirements. None of these requirements or restrictions are imposed on state banks or thrifts engaged in the same agency activities through subsidiaries.

Specific Concerns:

To compete effectively with other financial services providers, banks cannot be hobbled by provisions that unnecessarily restrict their options, flexibility, and efficiency. In some cases, it may be preferable for a bank to conduct activities through a subsidiary and, in other instances, through a holding company affiliate structure. Banks should be free to make these business decisions for themselves without government mandates. Without appropriate organizational flexibility, banks will be less safe and less sound, offer fewer choices to customers, and be less able to serve the financial needs of the their communities and customers.

- *Safety and Soundness Benefits:* With appropriate safeguards in place, the operating subsidiary structure is more safe and more sound than the affiliate structure.

-- First, income from an operating subsidiary flows to the bank, not the holding company, and, thus, provides a source of earnings that can serve as an important counter-cyclical, diversified source of funds for the bank. If banks cannot diversify their operations through a subsidiary, assets and activities will be siphoned from the bank to the affiliate, leaving the bank with a narrow base of activities and depleted assets. A "narrow bank" will be significantly less stable and more vulnerable to economic shocks than a fully diversified financial institution.

-- Second, if a bank needs to raise capital, it can sell the subsidiary. If the activities are in an affiliate, the funds from the sale of the affiliate will not flow to the bank.

-- Third, in the event of a bank failure, the FDIC would be able to sell the subsidiary. The proceeds from the sale would be available to the FDIC to reduce the costs of the bank failure that are borne by the taxpayer-backed deposit insurance fund. If the company were a bank holding company affiliate and not a subsidiary, the proceeds from the sale would not be available to protect the deposit insurance fund.

-- Fourth, subsidiaries of U.S. banks have for decades engaged overseas in activities, e.g., securities underwriting and merchant banking that are impermissible for the parent bank. U.S. banks' foreign subsidiaries represent our longest experience with securities underwriting and other expanded activities by companies under common ownership with banks. Thus, banks have experience in conducting these activities in a safe and sound manner.

-- For these reasons, current FDIC Chairman Tanoue and recent past Chairmen Helfer, Seidman, and Isaac have unanimously taken the position that these safety and soundness benefits make the subsidiary structure the preferable option.

• *Corporate Separateness:* Subsidiaries are (1) separately organized, (2) functionally regulated, (3) discrete corporate entities, and (4) distinct from the insured bank entity. These factors are common to both bank subsidiaries and holding company subsidiaries. Yet these factors are frequently cited as support for *mandating* the holding company subsidiary structure and *prohibiting* the equivalent use of bank subsidiaries for U.S. financial organizations. This

argument fails to consider that a bank subsidiary is an insulated, separate, corporate entity just like a holding company affiliate.

No Greater Risk to the Bank: The risks to the bank from activities conducted in a subsidiary with appropriate safeguards are no greater than if the activities are conducted in an affiliate with the equivalent safeguards. Various legislative proposals considered last year applied appropriate safeguards to bank subsidiaries.

-- Under the previous legislative proposals, a bank engaging in new financial activities through an operating subsidiary is required to deduct its investment in the subsidiary from capital and is not permitted to consolidate its assets with those of the subsidiary. Further, the bank must be well capitalized before and after taking the capital deduction. As a result, the bank can lose its entire investment in the subsidiary and remain well capitalized. If the subsidiary loses money, the liability of the bank is limited to its equity investment in the subsidiary and its well capitalized status is not affected.

-- As a further safeguard, transactions between the parent bank and a financial subsidiary are treated the same as transactions between a bank and a bank holding company affiliate for purposes of sections 23A and 23B of the Federal Reserve Act. These provisions require that loans and other covered transactions between the bank and its financial subsidiary are subject to collateral requirements and quantitative limits, and must be made on an arm's length basis. The parent bank's equity investments in the subsidiary would require regulatory approval if the amount that was being invested in the financial subsidiary exceeded the amount that could have been paid in a dividend to a bank holding company, without the approval of the regulator. Moreover, the requirement that the bank remain well capitalized after deducting its equity contribution to the subsidiary provides a significant constraint on downstream flows.

-- The holding company structure does not better insulate the bank from the risks of nonbanking activities as some claim. To the contrary, statistics demonstrate that, where corporate veil piercing occurs, it has more frequently occurred between companies that are affiliated by common control (i.e., the bank and a holding company nonbank affiliate) than

between a parent and its subsidiary.[1] Veil piercing depends on how the entities conduct their operations and not on how the operations are structured within an organizational chart.

- *No Greater Subsidy Transfer:* It has been suggested that only the affiliate structure effectively maintains competitive equity and prevents banks from transferring to nonbank affiliates any funding advantages that the banks may receive from deposit insurance, the availability of the discount window, and access to the payments system. But, there is no demonstrable evidence to support this claim.

-- After factoring in the costs of regulation and what banks pay for the services contained in the Federal safety net, it is difficult to argue that any net subsidy actually exists. Banks bear significant regulatory costs in return for access to the safety net. Among other things, banks are subject to laws and regulations that require regular examinations, and control exit and entry to the banking system, geographic and product expansion, fiduciary activities, the quality of internal and external information systems, and equal access to credit and other financial services. National banks also are subject to assessments, based on their assets. Taken together, these costs eliminate any net subsidy.

-- The way banks behave is further evidence that a net subsidy does not exist. If it existed, one would expect banks to behave in a manner to take advantage of the subsidy. This is not the case. For example, if banks realized a subsidy that lowered the cost of funds, banking organizations would be expected to issue debt exclusively at the bank level. Instead, we see debt issuances by all components of the organization -- banks, bank holding companies, and nonbank affiliates.

-- Moreover, if banks had a competitive advantage, they would dominate the nonbank financial services markets. However, in many fields, nonbank providers have a bigger market share than banks. As of June 1997, two

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[1] Thompson, Robert, "Piercing the Corporate Veil: An Empirical Study," *Cornell Law Review* 76 (July 1991), 1036-74.

of the top five largest servicers of residential mortgages were nonbanks, and two of the top five originators of mortgages were nonbanks.[2]

-- For the sake of argument (and despite the evidence to the contrary), even assuming that a net subsidy exists, there is no evidence that a bank holding company affiliate structure would be any more effective in containing the subsidy than the operating subsidiary structure, under equivalent safeguards. It bears repeating that these safeguards include (1) restricting the bank's equity investment in the subsidiary to the amount a bank could dividend to its parent bank holding company (unless the regulator permits a greater investment), (2) further limiting the size of the subsidiary by deducting the bank's investment in the subsidiary from the bank's capital and requiring the bank to remain "well capitalized" after the deduction, and (3) imposing the same limitations on transactions between the parent bank and the subsidiary that apply to transactions between the bank and its holding company affiliates.

-- Similar safeguards and restrictions were used by the Federal Reserve Board to justify its decision to allow foreign banks to have U.S. subsidiaries that engage in all aspects of securities underwriting in this country. In fact, the Board has approved some 18 foreign bank subsidiaries to engage in a full line of securities underwriting and dealing activities in the U.S., despite the fact that the parent bank has, according to the Board, the benefits of the bank's home country's safety net and a subsidized cost of funds. These decisions have allowed foreign banks to compete in the U.S. through the structure those banks find most effective, while denying similar opportunities to U.S. institutions. If the regulatory constraints are sufficient to wall off the flow of subsidized funds to foreign bank subsidiaries, why are they not sufficient to perform the same function for U.S. institutions?

- *CRA Benefits:* Foreclosing the subsidiary option diminishes the benefits of the Community Reinvestment Act (CRA).

-- The operating subsidiary structure enhances the bank's capacity to perform CRA activities. OCC examiners look at the assets and profitability of operating subsidiaries, among other performance context considerations, to ascertain a bank's capacity for performance.

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[2] "Ranking the Banks, Statistical Review 1997," American Banker.

- *Consumer and Community Bank Benefits:* Forcing most new financial activities to be conducted in holding company affiliates, limits the competitiveness of community banks, and deprives consumers of the benefits of competition in financial services and access to a full range of financial products.

  -- Denying banks the opportunity to organize their operations in the manner that is the most effective and efficient particularly impacts community banks. The subsidiary option may be the best option for community banks to offer their customers a full range of financial products in the most cost efficient manner.

  -- Allowing banks of all sizes to offer financial services using the most effective and efficient structure for that organization ensures that consumers will be able to have the benefits of competitively priced financial products and services, as well as access to the full range of these products and services.

3. BANK INSURANCE ACTIVITIES

H.R. 10 contains provisions that (1) permit states to impose discriminatory requirements on banks that limit their ability to compete in the sales of insurance products, (2) permanently freeze the ability of banks to produce new products if the product, or even a component of the product, is labeled "insurance," and (3) limit the traditional deference that the OCC would receive in conflicts with a state insurance regulator over interpretations of national banking law. As a result, banks cannot realize the safety and soundness benefits from true financial modernization by diversifying into new lines of business, and consumers will not realize the benefits of increased competitive pricing of insurance products and product innovation.

A. Insurance Sales Activities/Preemption

Under Section 121, well capitalized national banks may have a wholly-owned insurance agency subsidiary that may operate from any location in a state. But H.R. 10 does not repeal the "place of 5,000" restriction that limits banks' direct insurance sales under current law.

Section 104 establishes a complex scheme for determining the scope of permissible state regulation of insurance sales activities by banks and their subsidiaries and affiliates. The provision overturns the U.S. Supreme Court's decision in *Barnett*

Bank v. Nelson[3] and permits state regulators to impose rules that discriminate against banks and impose significant, anticompetitive, and in many cases virtually incomprehensible sets of restrictions on banks' ability to sell insurance. Under these new preemption standards, banks will have less protection from state discriminatory insurance sales restrictions than they do today.

Section 104 creates 13 safe harbors under which states may freely regulate bank sales of insurance without <u>any</u> limitations. The current version of H.R. 10 <u>expands</u> the safe harbors and the potential for increased litigation for banks.[4] It also includes any state law that is substantially the same as, but no more burdensome or restrictive than any of the 13 safe harbors that are expressly listed within the safe harbor protections.

Section 104 sets out a general rule that no state may -- "in accordance with" the preemption standards set forth in *Barnett* -- "prevent or significantly interfere" with the ability of a bank to engage in insurance sales or cross-marketing activities. In addition, for state laws that do not fall within the safe harbors, Section 104 differentiates between state laws enacted before or after September 3, 1998. For state laws enacted prior to September 3, 1998, the prohibition on a court giving traditional deference to the OCC's interpretation (described below) will not apply and the so-called nondiscrimination standards will not apply.

<u>Specific Concerns:</u>

- *<u>Barnett is Overturned:</u>* While H.R. 10 says that it codifies *Barnett*, its operative terms do not. The *Barnett* Court uses the words "prevent or significantly interfere"

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[3] *Barnett Bank v. Nelson*, 116 S. Ct. 1103 (1996).

[4] Two other provisions included in this version of H.R. 10 in Section 104 add to the issues that may prove troublesome to national banks. First, state antitrust laws and corporate laws of "general applicability" are exempt from the general rule that states cannot "prevent or restrict" a bank or its subsidiaries or affiliates from affiliating with any person as authorized by H.R. 10. The state laws that are protected from preemption under this provision may, however, have a disparate impact on banks and interfere with their ability to exercise Federally authorized powers. National banks have previously experienced problems with these types of laws. Second, an exception is made to another general rule that state laws cannot "prevent or restrict" the activities (other than insurance sales and cross-marketing activities which are subject to a different preemption standard) authorized by H.R. 10. This broad exception covers "state regulation of financial activities other than insurance." This provision is confusing and we cannot determine how it will work, why it is necessary, or what state laws will be covered.

and cites with approval various cases holding that state law is preempted if, for example, it encumbers, impairs the efficiency of, or hampers national bank functions. Thus, H.R. 10 would narrow the judicially developed, well-recognized and time-tested standards, making it easier for states to pass laws that impinge on national bank insurance sales authority.

- *"Safe Harbors" Allow States to Discriminate Against Banks:* The "safe harbors" give states the right to impose 13 types of restrictions on bank insurance sales, all of which permit discriminatory treatment of insured depository institutions. States also may add other restrictions that are substantially the same as the safe harbors.

B. Insurance Underwriting

Section 304 prohibits banks and their subsidiaries from underwriting new "insurance" products, unless the OCC had approved the product (except for annuities which are prohibited and title insurance which is restricted) as of January 1, 1997, or a national bank was actually offering the product as of that date. Insurance is broadly defined as (1) any product regulated as insurance as of January 1, 1997, (2) any product first offered after January 1, 1997, which a state insurance regulator determines shall be regulated as insurance and is not on a list in the bill of banking products, or (3) an annuity. Section 305 contains restrictions on title insurance underwriting by banks and their subsidiaries.

Specific Concerns:

- *Anticompetitive Requirements:* Section 304 may prohibit banks from offering new banking products that are authorized by the national bank charter. Any new banking product will be called into question if the regulator in the state where the product is provided labels it "insurance." Product innovation will be stifled. It is important to note that the consequence of a product being labeled "insurance" under this scheme is not that the product will be regulated as insurance, but that banks will be barred from providing it.

- *Undermines the National Bank Charter:* National banks will be exposed to the determinations of 50 different state insurance regulators. This means that a national bank may not be able to offer a product in one state that it is free to offer in another.

C. Deference

In a conflict with a state regulator over whether a product is insurance or banking (the answer to which determines whether a bank may produce a product after January 1, 1997 and not merely whether the product will be regulated as "insurance") or whether a state statute is properly treated as preempted, Section 306(e) provides that the OCC will not receive the traditional deference accorded to Federal agencies when interpreting the statutes they administer.

Specific Concerns:

- *Traditional Judicial Doctrine Overturned:* All Federal government agencies--including some of the more obscure agencies--are accorded deference on interpreting statutes they are charged with administering.[5] Although the 1984 U.S. Supreme Court decision in the *Chevron* case[6] represents the newest restatement of judicial deference doctrine, the Supreme Court has been giving weight to the construction of Federal statutes by executive branch officials since as early as 1809.[7] However, in an unprecedented step, Section 306(e) prohibits a court from giving the OCC deference even when the OCC is interpreting the National Bank Act, or even when the OCC is opining on whether a state law or rule interferes with the ability of a national bank to sell insurance. This result singles out national bank insurance activities and uniquely excludes OCC decisions in these areas from the long-standing doctrine of judicial deference.

- *Anticompetitive Consequences:* The result of this provision is to limit competition in insurance markets. This provision will have a chilling effect on bank business decisions to offer new products. The bank will no longer be able to rely on the OCC's decisions that have not been tested in the courts if a product may be deemed "insurance" by a state regulator.

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[5] We have found Federal cases, for example, that accorded deference to the Korean War Veterans Memorial Advisory Board, the Legal Services Corporation (which is a Federally-chartered corporation not subject to the full measure of the Administrative Procedures Act), the Pacific Northwest Electric Power & Conservation Planning Council, the Railroad Retirement Board, and the American Battle Monuments Commission.

[6] *Chevron v. Natural Resources Defense Council,* 467 U.S. 837 (1984).

[7] *See United States v. Vowell*, 9 U.S. (5 Cranch) 368, 371-72 (1809).

D. Other Issues

Section 301 restates that the McCarran-Ferguson Act is the law of the land. Sections 301 and 302 require all persons providing insurance in a state to be licensed in accordance with state law and all insurance sales activities to be functionally regulated by the state subject to the preemption standards in Section 104 (discussed above).

Specific Concerns:

- *Confusing and Conflicting Standards.* It is not clear what these provisions mean, why they are necessary, or how they will be interpreted and applied by a court. Retaining these ambiguous provisions in the legislation will only serve to expose banks to additional litigation risk.

4. BANK SECURITIES ACTIVITIES

Section 181 authorizes well-capitalized national banks and their subsidiaries to underwrite and deal in municipal revenue bonds. In other respects, H.R. 10 limits the ability of banks to engage in many currently permissible activities. Sections 201 and 202 repeal the broker-dealer exemptions for banks under Federal securities law, replacing them with a list of certain activities (interpreted and administered by the Securities and Exchange Commission (SEC)) in which a bank may engage without being required to register as a broker-dealer. These provisions have a "push-out" effect forcing banks to use separate legal entities to engage in many securities activities that banks provide today in a safe and sound manner. Under Section 206, the SEC has the authority to impose registration requirements on banks that effect transactions in or buy and sell new banking products that are determined by the SEC to be "securities" after consultation with the Federal Reserve Board--but with no other banking agencies. In addition, Section 121 contains amendments to current law to prevent subsidiaries of banks and thrifts from engaging in new securities underwriting activities after September 15, 1997.

Specific Concerns:

- *Current Safe and Sound Activities Will Be Forced Out of the Bank:* The various financial modernization legislation proposals under consideration contain provisions that will force banks to use separate legal entities in order to engage in many securities activities that banks currently provide. This is true because, as a practical matter, banks cannot register as broker-dealers due to the SEC net capital rules designed for securities firms rather than banks.

The proposals require banks to "push out" securities activities into separate securities companies, unless the bank only engages in currently permissible brokerage through a qualified networking arrangement with an SEC registered broker or dealer under conditions enforced by the SEC. Banks that sell, as agent, mutual funds or other securities (other than U.S. and municipal securities) must move the activity to separate SEC-regulated legal entities, either bank subsidiaries or holding company affiliates. In addition, Section 201 inserts back into the bill similar provisions that were struck by the Senate Banking Committee preventing a bank from engaging in private placements of securities if it is affiliated with a securities firm. Other current activities will be subject to limitations. The activities affected include: loan sales or participations if the loans were not "made by a bank," variable annuity sales, securitization of assets if "predominantly originated by the bank or its affiliate," and 401(k) and other securities purchase plans if the bank is not the transfer agent for the securities offered by the plan.

- *Community Banks Will Be Particularly Disadvantaged.* The expanded securities powers under H.R. 10 (except underwriting municipal revenue bonds) are available only to holding company affiliates. Requiring this structure will impose operating burdens and relatively larger costs on smaller banks that do not have a holding company structure in place. Effectively, many community banks will not be able to take advantage of the new authority or will be uncompetitive due to the relatively higher cost of the holding company affiliate structure.

5. BANK SUPERVISION

H.R. 10 contains several provisions that give the Federal Reserve Board confusing, overlapping authority over depository institutions that are regulated by other Federal banking agencies. For example, as a requirement to engage in the new financial activities, Section 103 requires all subsidiary depository institutions of a financial holding company to be well capitalized. If the Federal Reserve Board determines that a financial holding company has a subsidiary depository institution that is not well capitalized, or well managed, the company must execute an agreement with the Board to correct the deficiency. Until the conditions are corrected, the Board may impose limitations on the activities of the company or any affiliate, including a depository institution. Section 114 gives the Board additional authority to impose restrictions and requirements on relationships or transactions between a depository institution subsidiary of a bank holding company and any affiliate of the depository institution (other than a subsidiary of the institution). The Board may impose these restrictions if it determines, among other

things, that the restrictions are necessary to avoid significant safety and soundness risk to the depository institution or the Federal deposit insurance fund.

Specific Concerns: These provisions will subject depository institution subsidiaries of bank holding companies to unprecedented, new regulatory burdens and overlapping, potentially conflicting, regulatory requirements.

6. CONSUMER PROTECTIONS

Section 307 requires the Federal banking agencies to prescribe joint consumer protection regulations that would apply to retail sales and advertising of any insurance product by an insured depository institution, wholesale financial institution (WFI), subsidiaries thereof (as deemed necessary), and employees/agents thereof.

The regulations must include, for example, (I) a prohibition on misrepresentation (*e.g.*, "any practice" that "could mislead any person or otherwise cause a reasonable person" to conclude erroneously that the product is insured); (ii) a prohibition on coercion (*e.g.*, "any practice that would lead a consumer to believe" that credit is conditional upon the purchase of a particular insurance product); (iii) disclosure requirements to inform the consumer that the product is not insured and is subject to anti-coercion rules; (iv) requirements that insurance transaction activities be physically separated ("to the extent practicable") from areas where retail deposits are routinely accepted; (v) restrictions on referral compensation; (vi) requirements that insurance sales agents/employees be appropriately qualified and licensed; (vii) procedures to receive complaints by consumers alleging violations of these provisions; and (viii) a prohibition on discrimination (except as expressly permitted under state law) against victims of domestic violence. We generally support these types of consumer protection requirements, many of which are substantially similar to protections found in the OCC's October 8, 1996 Guidance.

Specific Concerns: This section also establishes a new preemption scheme prohibiting an "inconsistent" or "contrary" state provision from being preempted by the Federal regulations unless the Federal banking agencies jointly make certain determinations. This provision is extraordinarily convoluted and presents the astonishing prospect that in each state, banks selling insurance would be subject to a different combination of provisions of the Federal rules, state provisions that co-exist with the Federal rules, state provisions that supersede the Federal rules and state provisions that are superseded by the Federal rules. The mix of these provisions could be different in each state in which a bank sells insurance.

7. COMMUNITY REINVESTMENT ACT

Under this version of H.R. 10, for a bank holding company to engage in new financial activities, all of its subsidiary depository institutions must have a satisfactory CRA rating at the time the holding company applies to become a "financial holding company." A similar requirement is made applicable to national banks seeking to engage in financial activities through a subsidiary. Section 136 of the bill applies CRA to national and state bank WFIs.

Specific Concerns:

- CRA has achieved positive results, and has led to significant financing for affordable housing, economic revitalization for communities, and increased profitable lending opportunities for banks. As a result, the OCC supports the approach taken in the House-passed version of H.R. 10, which would apply a satisfactory CRA requirement on an on going basis.

8. PRIVACY OF BANK CUSTOMERS

The consumer financial privacy provisions in H.R. 10 include: (1) Section 114 permits the Board to impose restrictions or requirements on relationships or transactions between a depository institution and any affiliate (except a subsidiary of the depository institution) if it enhances the privacy of customers of depository institutions, is found to be in the public interest, and is consistent with various Federal laws; (2) Section 104 (addressing Federal preemption standards) permits states to adopt laws to prohibit the release of certain customer insurance information for the purpose of soliciting or selling insurance (or health information for any purpose) without the customer's express consent; and (3) Section 109 provides that the ongoing, multi-stage Federal Trade Commission study on consumer privacy issues will be submitted to Congress at the conclusion of each stage, together with recommendations for legislative action.

Specific Concerns: Technological advances and the emergence of diversified financial services companies--which would intensify upon the enactment of H.R. 10--creates a parallel responsibility for policymakers to ensure that customers' private financial information is properly handled and appropriately safeguarded.

- *FCRA Should Be Amended to Restore the Federal Bank Regulators' Examination Authority:* Recent amendments to the Fair Credit Reporting Act (FCRA) allow persons related by "common ownership or affiliated by corporate control" to share

and use any customer information they possess (in addition to experience information, which can be freely shared) subject to certain requirements. This information may be shared within the corporate family only if clear and conspicuous disclosures are made to consumers that the information may be shared under FCRA and consumers are given the opportunity to "opt-out" of any information sharing.

The same recent amendments to FCRA also restrict the Federal banking agencies' authority to examine for compliance with FCRA, including the information sharing and opt-out provisions. A Federal banking agency may only examine an institution for FCRA compliance if the agency has information--following an investigation of a complaint or otherwise--that an institution has violated FCRA. Absent these circumstances, a banking agency cannot examine for compliance with the FCRA information sharing requirements. It is recommended that full examination authority for the Federal banking agencies be restored.

9. NATIONAL WHOLESALE FINANCIAL INSTITUTIONS

Section 136 creates both national and state bank WFIs. These uninsured institutions can be affiliated with insured depository institutions. The bill prohibits WFIs from accepting initial deposits of $100,000 or less (except for a 5% *de minimis* amount). While the OCC is given chartering authority over national WFIs, national WFIs in all other respects are supervised and regulated by the Federal Reserve Board.

Specific Concerns: National WFIs will be subject to duplicative, confusing regulation--chartered by the OCC but, for all other purposes, including prompt corrective action, supervised by the Federal Reserve Board and subject to the Board's enforcement authority. This is tremendously inefficient and confusing.

Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

March 24, 1999

The Honorable Sue W. Kelly
United States House of Representatives
Washington, D.C. 20515

Dear Congresswoman Kelly:

Thank you for your inquiry following my February 12, 1999, appearance before the Committee on Banking and Financial Services.

Q: I want to gauge all of your support or opposition for the mixing of commerce and banking. Please tell me if you would favor a basket approach or for H.R. 10 to remain as it is now without a mix of banking and commerce. Briefly explain your position.

A: The OCC's view is that reconsideration of the separation of banking and commerce in the United States is a step that requires great deliberation and care. We have the time we need to proceed cautiously since, at present, there is no pressure from the marketplace to mix banking and commerce. Further, the financial crisis that has affected many parts of the world over the past two years provides an important reason for us to fully explore the implications of such proposals for the safety and soundness of commercial banks. Under these circumstances, I would prefer H.R. 10 as reported by the Committee on Banking and Financial Services.

Sincerely,

John D. Hawke, Jr.

John D. Hawke, Jr.
Comptroller of the Currency

Statement

of

Ellen Seidman
Director

Office of Thrift Supervision

concerning

Financial Modernization

before the

Committee on Banking and Financial Services
U.S. House of Representatives

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Statement of Ellen Seidman, Director
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on
Financial Modernization and H.R. 10
before the
Committee on Banking and Financial Services
of the
United States House of Representatives

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I. Introduction

Mr. Chairman and members of the Committee, I appreciate the opportunity to discuss the Office of Thrift Supervision's views on financial modernization and your bill, H.R. 10, the "Financial Services Act of 1999."

Last year, Congress made tremendous strides in its efforts to modernize America's financial services industry. Today, we have been asked to consider legislation that builds on the work of the 105th Congress. Many of the same issues remain—and we must work together to resolve these differences—but ultimately the question we must ask is whether proposed legislation will facilitate the ongoing movement of our financial system into the twenty-first century. Because regardless of what happens in the coming weeks and months on the legislative front, the market will continue to modernize. Legislation should facilitate this trend, promoting flexibility for existing, and future, financial institutions, including insured depositories, while maintaining a framework to ensure the system's continued safe and sound operation, fair service to all, and the health and stability of the national and global economies.

In my statement, I will first articulate four principles we believe should guide financial services modernization legislation. I will then discuss several characteristics of the federal thrift charter we believe should be preserved and, potentially, modeled in developing new alternative structures, including several issues that are particularly important to us in this debate. I will then comment on your articulated goals, Chairman Leach, for financial services modernization legislation and reflect on these in light of our experience with the federal thrift charter. Finally, I will address several aspects of H.R. 10, introduced by Chairman Leach, and H.R. 665, introduced by Congressman LaFalce earlier this week.

II. The Principles of Financial Modernization

We believe several principles are paramount as Congress moves forward in developing and enacting legislative reforms affecting the future of the financial services industry. Such legislation must:

- Preserve adequate regulatory authority to protect the safety and soundness of insured institutions and the federal deposit insurance funds, and to protect consumers in their dealings with financial institutions;

- Maintain marketplace incentives to facilitate the ability of institutions to continue to provide consumer- and community-based financial services to all Americans, in all communities;

- Enhance structural and operational flexibility so insured depository institutions can compete effectively with other financial services providers; and

- Minimize regulatory burdens on insured depository institutions, consistent with safety and soundness and the consumer protection and community reinvestment laws.

These criteria balance flexibility for institutions—so that marketplace innovations that benefit customers, communities and the financial system are not impeded—with appropriate regulatory safeguards. The thrift charter represents one model of a modern charter with a community- and consumer-based focus. It also offers substantial flexibility in that it affords benefits and advantages both to small community-based institutions and larger regional and national providers of financial services.

III. Characteristics of a Modern Charter—the Federal Thrift Charter

1. Permissive Affiliation Authority

While the federal thrift charter is certainly not the only way to structure a modern charter, it is a model worth studying. The federal thrift charter provides a unique combination of permissible affiliations and restrictive operating conditions. The unitary thrift holding company is a good example. Much has been made of the fact that a thrift may be owned by or affiliated with any type of commercial entity. Glossed over in this debate are the restrictions under which the thrift itself must

operate, as well as an appreciation for the historical framework for regulation of the unitary structure (which is described in the appendix to this statement).

Federal thrifts are barred, by section 11(a) of the Home Owners' Loan Act ("HOLA"), from making any loans or extending credit to affiliates not engaged in activities permissible for a bank holding company under section 4(c) of the Bank Holding Company Act. This prohibition serves as an absolute limitation on a thrift's ability to engage in the types of affiliate commercial lending that are at the heart of the concern about mixing banking and commerce. HOLA § 11(a) goes well beyond the affiliate transaction restraints of sections 23A and 23B of the Federal Reserve Act (to which thrifts are also subject).

In addition, federal thrifts are constrained in the amount of their overall commercial lending. By statute, a thrift may not hold commercial loans in excess of 10 percent of its assets, except that it may make small business loans up to an additional 10 percent of assets. This provision, coupled with the qualified thrift lender restriction imposed on thrifts—which requires 65 percent of thrift assets to be in mortgages, mortgage-related investments, education and certain consumer and small business loans—effectively constrains the ability of thrifts to engage in traditional commercial bank lending activities.

OTS' capital distributions regulation also limits the amount a thrift may dividend or otherwise distribute to its parent holding company. The amount of a dividend or similar distribution is based on the capitalization level of the thrift institution. In no event may a thrift make a dividend that would impair its capital. In addition, thrifts—like banks—are subject to increasingly stringent activities, dividend, growth and other restrictions that protect the institution if its capitalization falls below designated capital levels.

Finally, statutory anti-tying restrictions generally prohibit a thrift from conditioning extensions of credit, providing credit on more favorable terms, or the furnishing of services to a customer on the requirement that the customer obtain certain other services from an affiliate of the thrift. These restrictions address another concern that arises in the banking and commerce debate: the unfair use of market power to coerce banking consumers to purchase non-banking products and services, which also, in turn, unfairly disadvantages competitors.

In fact, commercial ownership of thrifts remains limited. Currently, only 24 of the 547 existing thrift holding company structures have commercial activity within them. Another 25 holding companies have some amount of real estate

development in their structure.[1] This despite the fact that for several years there have been serious efforts to prohibit commercial firms from acquiring or chartering thrifts in the future. In fact, most of the small number of commercial firms that now own a thrift charter do so because the focus of their commercial activity is consumer, rather than business, oriented. These companies view the thrift charter as a way to extend and diversify their consumer business operations.

Despite the relatively small percentage of commercial ownership of thrift institutions both today and historically, commercial firms have made significant capital contributions to the industry. For example, we are aware of over $3 billion of capital infused in 79 failed thrifts by commercial firms during the late 1980s.

With respect to reports regarding an increase in new thrift charter applications, the vast majority of recent charter applications come from groups of individuals and insurance and securities companies, not commercial firms. Insurance and securities companies could, of course, own a commercial bank were H.R. 10 enacted in its current form. Insurance and securities applicants are seeking to use the operating and marketing synergies available between their existing business and product lines and those available with ownership or affiliation with a thrift.

Predictably, there have been some tricky policy and supervisory issues raised by some of the new applications, particularly with the proposals that have involved unique business plans and strategies. Some of these applications have required difficult regulatory analysis and novel responses. We thoroughly consider all relevant safety and soundness, compliance, consumer protection and related issues prior to our action on each individual application. OTS conditions of approval typically require applicants to implement adequate internal controls, training programs and reporting mechanisms that ensure effective oversight, and protect the safety and soundness of the institution and the federal deposit insurance funds. I have heard that some applicants have become so perplexed about the care we exercise in reviewing unique business strategies that they question whether we have a self-imposed moratorium on new charters. I can assure you, we do not.

[1] Pursuant to HOLA § 5(t)(5), enacted as part of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 ("FIRREA"), savings associations owning subsidiaries engaged in real estate development activities must separately capitalize their investments in such subsidiaries. This requires the full amount of a thrift's investment in a real estate development subsidiary to be deducted from the thrift's capital. As a result, after FIRREA most thrift real estate development subsidiaries were either divested or (for institutions in a holding company structure) the activities were moved to a holding company affiliate of the thrift. Currently, thrift investments in real estate development (and other non-includable) subsidiaries amounted to approximately 0.04 percent of total thrift assets. Because (pursuant to another FIRREA provision discussed above) thrifts are prohibited from making loans to affiliates not engaged in permissible bank holding company activities, a thrift is prohibited from funding the activities of such a real estate development affiliate.

2. Uniform Standards of Operation

Another example of the balance in the federal thrift charter is the inherent tie between its consumer lending focus and the ability to operate under uniform federal standards. Unlike commercial banks, federal thrifts are statutorily required to direct the predominant portion of their lending activities to consumers—via home lending, consumer loans, education loans, and credit card lending. One of the trade-offs for this consumer lending focus is that federal law affords thrifts the opportunity to engage in these activities on a nationwide basis. Congress has recognized the value of permitting these institutions to conduct their lending and deposit-taking activities subject to a uniform, federal system of oversight, requiring in HOLA that in regulating federal thrifts, we give "primary consideration of the best practices of thrift institutions in the United States." Practically, this means that these institutions need comply with one set of federal laws governing their lending and deposit-taking activities, instead of the laws of each of the states where they may conduct their operations.

This authority to establish uniform federal standards is, however, limited. OTS regulations—adopted after public notice and full opportunity for comment—specifically delineate areas where we generally determine that federal law does not preempt state laws because of the states' legitimate interest in enacting contract and commercial laws, real property laws, criminal laws, tort laws, and any other laws that further a vital state interest and have an incidental impact on thrift operations. For example, several years ago we were asked to preempt a Georgia law requiring lenders to perform the ministerial function of collecting a "per loan fee" from borrowers and transmitting it to the State. The Georgia law involved a relatively minor burden, which applied to all mortgage lenders in the State, and the collection requirement was incidental to the safe and sound operation of Georgia thrifts and did not interfere with the efficient production of mortgage loan originations. Thus, we concluded that the State provision was not preempted by federal law.

More recently, we were asked to preempt a New York law setting forth lighting requirements for ATM machines, a provision intended to ensure the security of customers using ATM facilities within the State. Recognizing the State's overriding interest in protecting the security of its citizens, we concluded that the New York provision was not preempted by federal law—a result clearly consistent with the criteria set forth in our regulations

3. Consolidated Regulatory Oversight and Functional Regulation

A final important characteristic of the federal thrift charter is its ability to provide a combination of consolidated regulatory oversight and functional regulation. If a holding company's financial services are provided only through savings associations, OTS is the consolidated federal regulator for the savings associations, their subsidiaries and their holding companies. This approach is unique for federally chartered institutions and has worked well. We have access to information on all aspects of the institution's operations and provide the institutions with "one-stop" regulatory oversight that is focused primarily on the safe, sound and compliant operations of the thrift.

If the holding company's structure includes insurance or securities firms, then its components are functionally regulated. Functional regulation also applies where thrifts engage in insurance and securities activities through subsidiary service corporations or affiliated holding company subsidiaries. Service corporations and holding company affiliates engaged in insurance activities must be licensed and regulated by the appropriate state insurance regulator, and those engaged in securities activities must register with the Securities and Exchange Commission ("SEC") and their appropriate self regulatory organization ("SRO"), such as the National Association of Securities Dealers ("NASD"). Primary oversight of insurance and securities activities remains with the functional regulator (i.e., state insurance and securities commissioners and the SEC and NASD or other SRO), with whom the OTS works closely when an issue affecting the thrift or its charter arises.

Not only does this unique approach benefit OTS-regulated thrifts by avoiding regulatory overlap, it embraces a common-sense regulatory division of labor while maintaining the ability of the OTS to monitor all aspects of a structure to protect the safety and soundness of the thrift. This combination of consolidated regulatory oversight and functional regulation is certainly worth preserving, and seriously worth considering as a broader model for consumer-oriented financial institutions.

IV. Goals of Financial Modernization

When you and your colleagues introduced H.R. 10 this year, Mr. Chairman, you indicated that financial services modernization legislation should pursue several goals:

- Leveling the competitive playing field within the financial services industry;

- Increasing competition so that the costs of financial services are lowered for consumers;

- Boosting the international competitive position of American firms; and

- Providing consumers and smaller businesses in more rural areas with access to a wider variety of financial products by enabling local institutions to offer a full range of products and services.

We agree with these stated objectives, provided that in pursuing legislative efforts to attain these goals we do not sacrifice the stable underpinnings of our existing financial services system. That is, the stated goals of financial modernization should be pursued in a manner consistent with the principles of financial modernization I previously articulated.

With these goals of financial modernization in mind, and with a watchful eye on maintaining existing checks and balances in our financial system, I briefly want to evaluate how the thrift charter measures up. As to the level playing field objective, it is quite clear that the thrift charter has enabled insurance and securities firms to own depository institutions—if the institutions concentrate on consumer lending and operate within statutory commercial lending limitations. This absence of competitive barriers to entry seems to be at the heart of creating a level playing field.

Next, with respect to increased competition and reduction in the costs of financial services to consumers, although the absolute number of thrifts continues to decline, competition has been enhanced as existing thrifts and new entrants have provided more choices for consumers through innovative products and new service delivery systems. This influx of new financial products and increase in delivery systems clearly is increasing competition—and will reduce costs to users of financial services. The innovation and expansion of delivery systems can also expand access to services of depository institutions in communities that have limited access to these products.

As for international competitiveness, the thrift charter has had very limited exposure to international operations. The charter is virtually an exclusively domestic charter.

With respect to providing consumers and small businesses in more rural areas with greater access to financial services, the thrift charter has been empowering local, community-based institutions for years to offer a full range of

financial products and services. The charter is well-suited to this in both underserved rural and urban areas, with thrifts offering a full range of consumer deposit and loan products.

Through service corporation subsidiaries, thrifts also provide securities and insurance brokerage services, and a statutorily limited amount of real estate development activities. Thrifts also have the flexibility to offer products and services that could be conducted in the thrift itself, such as mortgage banking, through an operating subsidiary. Finally, thrifts may be part of a corporate structure that conducts additional, non-banking lines of business. On this final point, because of the commercial lending, anti-tying, and other limitations imposed on the thrift charter, this is accomplished without triggering the traditional concerns raised with mixing banking and commerce.

V. Comments on H.R. 10

For these reasons, I believe the federal thrift charter is a good model for a modern federal depository institution charter. We therefore oppose provisions of H.R. 10 that would restrict existing and future, lawful unitary thrift holding company activities and that would amend existing authority for federal thrifts to operate under uniform standards nationally. We believe the safeguards currently in place are effective and the charter should not be altered as proposed in H.R. 10.

We continue to support a merger of the federal deposit insurance funds. The insurance funds should be merged, whether as part of broad financial modernization legislation or via some other legislative vehicle. We need to eliminate the economic and managerial inefficiencies of a two-fund structure for what is essentially one product—insured deposits.

Market forces have already begun this process. It is becoming increasingly anachronistic to refer to a "bank fund" and a "thrift fund." The overlap between the two funds has been an open secret for some time. As of September 30, 1998, over 35 percent of total SAIF-insured deposits ($246 billion) were held by commercial banks and almost 29 percent of savings institution insured deposits ($185 billion) were insured by the BIF.

Both industries are sound and healthy, and both funds are well-capitalized. Now is the ideal time to do what sound public policy clearly tells us must be done: merge the two funds. Thus, we urge that H.R. 10 include merger of the federal deposit insurance funds.

Finally, I want to applaud the Chairman for including in H.R. 10 elimination of the SAIF special reserve. Because the FDIC is required to maintain the SAIF (or the combined BIF-SAIF) at a 1.25 percent reserve ratio and must raise deposit premiums (up to 23 basis points annually) to do so, it is highly unlikely that the reserve will ever be utilized. In essence, the establishment of the SAIF special reserve transferred to a special fund over $1 billion of the $4.5 billion that institutions with SAIF-insured deposits contributed to the SAIF in 1997 to fully capitalize the fund.

A greater concern is that funding of the reserve pares the SAIF reserve ratio from an estimated 1.39-1.41 percent—which is equivalent to the BIF ratio—to 1.25 percent. The FDIC established the reserve on January 1, 1999, using September 30, 1998 data, and will adjust the amount (approximately $1 billion) to reflect year-end figures when they become available this spring. Funding the reserve eliminates the capital cushion of the SAIF to absorb insurance losses above those covered by fund earnings and incremental premiums. The FDIC is now estimating that the SAIF will grow a maximum of $200 million during the first six months of this calendar year. While no one anticipates significant claims, this new $200 million cushion is relatively small, and it exposes SAIF institutions to increased premiums and, once again, a BIF-SAIF premium differential. It would not be surprising if this triggered another wave of that singularly most pointless of financial transactions: deposit-shifting.

The only way to resolve this problem is to eliminate the special reserve and return the funds to the SAIF. This will restore the capital cushion of the SAIF (or a combined fund in the event of a merger) and avoid the possibility of future, increased SAIF assessments where a substantial reserve already exists but cannot be used. We support legislation that achieves this result.

VI. Other Legislative Proposals

Earlier this week, Ranking Minority Member LaFalce introduced H.R. 665, the "Financial Services Modernization Act of 1999," which is co-sponsored by other members of the Committee. H.R. 665 takes a simpler approach to financial services modernization legislation and has many attractive features. It focuses only on the key elements necessary for financial modernization, and thereby avoids some of the pitfalls of other approaches. Among the key elements included in the bill are repeal of the Glass-Steagall bank/securities firm anti-affiliation rules; authority for bank holding companies to engage in financial activities specified by law plus others determined by the Federal Reserve Board; streamlining of bank holding company supervision while enhancing functional regulation; and strong protections for consumers who purchase insurance products from financial institutions.

OTS is pleased that H.R. 665 retains the existing federal thrift structure, including leaving the unitary thrift holding company in place. This recognizes the advantages of retaining the unitary structure as a vehicle to offer a full range of locally focused, consumer-oriented financial services. The bill would give institutions the freedom to choose whether the unitary structure suits their particular business goals and needs.

If H.R. 665 becomes the model for financial modernization legislation, we would urge the addition of amendments to merge the federal deposit insurance funds and eliminate the SAIF special reserve.

VII. Conclusion

Mr. Chairman, I am pleased to provide you with OTS' views on financial modernization. Despite our serious concerns regarding some of the provisions in H.R. 10, I want to emphasize that we support efforts to modernize the federal laws governing the provision of financial services in the United States. We believe modernization must provide the tools necessary to assure the safety and soundness of the national banking system and protect the American public in its dealings with these institutions, result in consumer- and community-based financial services for all Americans, provide structural and operational flexibility for insured institutions, and minimize regulatory burdens.

Consistent with these goals, OTS urges the Committee to retain the existing thrift charter as one model of a modern charter. It permits affiliations of insured depository institutions with insurance, securities and other firms, but with built-in safeguards to avoid undue risks to the taxpayer and to meet the needs of consumers and communities. Based on our experience, there is no reason to believe that affiliations permitted in the unitary thrift holding company structure are inherently risky and should be constrained. In fact, there are numerous reasons to retain the structure in its current form. Similarly, we support retaining existing federal law that facilitates implementation of federal thrifts' mandate to operate under uniform national standards based on the "best practices" found throughout the country. Finally, we urge the Committee to take the opportunity presented in H.R. 10 to merge the two federal deposit insurance funds and eliminate the SAIF special reserve.

I look forward to working with you during the 106th Congress toward the enactment of financial modernization legislation that achieves these goals. Thank you.

APPENDIX

OFFICE OF THRIFT SUPERVISION

Business Transactions Division Memorandum:

Historical Framework for Regulation of Activities of Unitary Savings and Loan Holding Companies

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May 6, 1998

HISTORICAL FRAMEWORK FOR REGULATION OF ACTIVITIES OF UNITARY SAVINGS AND LOAN HOLDING COMPANIES

I. Introduction

The term "unitary savings and loan holding company" or "unitary thrift holding company" is a shorthand description of a corporate structure in which a company (or group of companies) controls a single savings association. The significance of this structure is that the holding company may engage in any legitimate business activity that it chooses; it is free from the activities restrictions that apply to bank holding companies.[1]

Why Congress has chosen, as it considers regulation of the holding companies of insured depository institutions, to treat unitary thrift holding companies differently from bank holding companies is the subject of this memorandum. The evolution of the unitary thrift holding company as a structure warranting different regulatory treatment reflects a number of changing public policy considerations that have been before Congress in the last thirty to forty years.

Initially, Congress was concerned with the perceived dangers presented by multiple holding companies, as opposed to unitary holding companies, even where the subsidiary was a bank. When Congress first enacted legislation in 1967 to regulate savings and loan holding companies, unitary or one-bank holding companies were exempt from the Bank Holding Company Act ("BHCA") and its restrictions on unrelated business activities. To qualify as a bank holding company at that time, a company had to control two or more banks. Partially in recognition that the BHCA restrictions applied only to multi-bank holding companies, Congress imposed activities restrictions only on multiple savings and loan holding companies.

Congress also recognized, however, the difference between, on the one hand, the traditional thrift focus on home mortgage lending and ancillary consumer services and, on the other hand, the commercial lending and more wide-ranging business-oriented services provided

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[1] This is, of course, changing. The Federal Reserve Board ("FRB") has permitted bank holding companies to engage in securities activities through so-called section 20 nonbank subsidiaries, although until recently such a subsidiary could earn only 10% of its total revenue from underwriting or dealing in securities ineligible for member bank investment ("bank-ineligible securities"). The FRB recently raised the revenue limit for such subsidiaries to 25% of bank-ineligible securities (61 Fed. Reg. 68750 (Dec. 30, 1996)), sparking a number of bank acquisitions of investment banking firms. Additionally, within the last year, the Office of the Comptroller of the Currency ("OCC") has indicated that a subsidiary of a national bank may be permitted to engage in non-banking activities. *See* 61 Fed. Reg. 60341 (Nov. 26, 1996).

by banks. In recent years, the major thrust of legislation has been aimed not at curbing the unrelated business activities of thrift holding companies, but rather at reinforcing the residential and consumer lending mission of their subsidiary associations. Congress first imposed a "qualified thrift lender test" ("QTL test") of "thriftness" on savings associations in 1987. Failure of a savings association to meet the QTL test can lead to substantial operational sanctions for a subsidiary thrift, and, more significantly, to required divestiture of non-banking business activities for the parent unitary holding company.[2] Two years later, Congress barred thrifts from making loans or extension of credit to affiliates engaged in non-banking activities.

The contemporaneous legislative history of the BHCA reflects different concerns. These have been framed as potential systemic threats presented by large one-bank and multi-bank holding companies that may form powerful banking/industrial conglomerates and possibly monopolize commercial credit. Congress has not historically expressed the same concern with respect to the interrelationship of activities of unitary savings and loan holding companies.

II. Comparison of Treatment of Business Activities of Unitary Savings and Loan Holding Companies and Bank Holding Companies

a. Bank Holding Company Background

Modern statutory regulation of bank holding companies at the national level began in 1956[3] when Congress identified two areas of concern about bank holding companies:

> (1) The unrestricted ability of a bank holding company group to add to the number of its banking units, made possible the concentration of commercial banking facilities in a particular area under a single control and management; and
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> (2) the combination under single control of both banking and nonbanking enterprises, departed from the principle that banking institutions should not engage in business wholly unrelated to banking.[4]

With regard to the first issue, the potential for the "monopolistic control of credit"[5] in

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[2] *See, e.g.*, 12 U.S.C. § 1467a(m)(3).

[3] Bank Holding Company Act of 1956, ch. 240, 70 Stat. 133 ("BHCA of 1956"). Ten years later, the BHCA of 1956 was modified by amendments generally unrelated to nonbanking activities. Act of July 1, 1966, Pub. L. No. 89-485, 80 Stat. 236 and 237 ("1966 BHCA Amendments").

[4] S. Rep. No. 1095, 84th Cong at 2 (1955). Although the principle has been challenged of late, the Senate Committee then observed that the combination of banking and nonbanking enterprises under common control "constituted a departure from the established policy of separating banking from other commercial enterprises." *Id.*

[5] H.R. Rep. No. 609, 84th Cong. at 2 (1955).

different areas of the country, Congress directed the Federal Reserve Board to review bank acquisitions under several standards, including the possible effect on competition.[6] This approval process covered, however, only those acquirers that already owned at least one bank subsidiary.[7] The initial acquisition by a holding company entering the banking industry was not subject to this process, for several reasons. As the Senate Banking Committee later observed, unitary bank holding company operations in the mid-1950s were generally small and presented no serious supervisory problems.[8] Additionally, since banks were at the time subject to sometimes stringent state branching laws, a multiple holding company provided a possible vehicle for circumventing the laws.[9] Unitary holding companies could not, by definition, present such a risk. Congress also believed that blanket coverage by the BHCA would tend to discourage formation of new banks and force the sale of many existing banks.[10] This Congressional decision that only multiple bank holding companies were to be covered by the BHCA of 1956 was not modified by amendments to the BHCA in 1966.

As to the concern over the combination of banking and nonbanking activities under the holding company umbrella, i.e., the unrelated business activity issue, bank holding companies were generally prohibited, with certain limited exceptions, from owning shares in nonbanking companies. The major exception for nonbanking activities pertained to the acquisition of shares in "any company all the activities of which are of a financial, fiduciary, or insurance nature," which the FRB has found to be "so closely related to the business of banking . . . as to be a proper incident thereto."[11]

The latter provision, which governed the ability of bank holding companies to engage in otherwise nonexempt unrelated activities prior to the end of 1970, was strictly applied by the FRB. As a result, multiple bank holding companies were severely circumscribed in the types of nonbanking activities in which they could engage during that period. This limitation, however, did not apply to one-bank holding companies.

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6 Bank Holding Company Act of 1956, ch. 240, § 3(c), 70 Stat. 135.

7 *See* S. Rep. No. 1095, 84th Cong., at 5 (1955). "At that time only relatively small, rural and smalltown banks were exempted from bank holding company regulations by the so-called one-bank exemption." H.R. Rep No. 91-387, at 2 (1969).

8 S. Rep. No. 91-1084, at 2 (1970).

9 H.R. Rep. No. 609, 84th Cong. at 3, 4 (1955).

10 *Id.*

11 Bank Holding Company Act of 1956, ch. 240, § 4(c)(6), 70 Stat. 137., Section 4(c)(6) was modified slightly by the 1966 BHCA Amendments and redesignated section 4(c)(8) Pub. L. No. 89-485, § 8(b), 80 Stat. 269 (1966). Of course, at that time (and through the present), there were statutory provisions outside the BHCA that affected a bank holding company's ability to engage in nonbanking financial activities. *See, e.g.*, section 20 of the Glass-Steagall Act (barring member bank affiliations with investment banking firms) (12 U.S.C. § 377)

b. Savings and Loan Holding Company Background

When savings and loan holding companies first came to the attention of Congress in the late 1950s, their numbers were few and opportunities for growth limited. The subsidiary thrift in a savings and loan holding company structure had to be in the stock form of ownership. Most of the nation's savings institutions were organized as mutuals, but all federally chartered associations, which constituted the majority of savings institutions, were required by statute to be mutuals. In contrast to their banking counterparts, savings and loan associations were basically restricted to local residential home mortgage lending and ancillary activities. Indeed, there were statutory restrictions on the geographic areas in which insured thrifts could make home mortgage loans and rates on deposit accounts were fixed by regulation.

Holding companies of state-chartered thrifts did exist, however, and there were no federal limitations on the nonthrift business activities in which they could be engaged. By the late 1950s, twenty states and Guam had laws permitting formation of stock savings and loan associations. Congress took notice of an "accelerating trend of acquisitions of stock savings and loan associations by savings and loan holding companies" and concluded that "stopgap legislation" was needed to arrest the probable acquisition of "most of the assets of the stock savings and loan institutions . . . [by] holding companies."[12]

From testimony at hearings in 1959, the Senate Banking Committee foresaw other potential problems if holding company acquisitions of thrift institutions were to continue unchecked. These concerns included monopoly and restraint of trade, financial manipulation and intercorporate dealings, and absentee ownership.[13] As a result of these findings, Congress imposed two significant restrictions on holding company control of thrifts in 1959. First, Congress essentially prohibited existing holding companies from acquiring any additional insured thrifts. Second, any other company was limited to the acquisition of one thrift. This temporary legislation, known as the Spence Act, did not prohibit or restrict the nonthrift-related business activities of existing savings and loan holding companies. The Federal Home Loan Bank Board ("FHLBB") was directed to make legislative recommendations to Congress on the overall regulation of savings and loan holding companies.[14]

Although the FHLBB submitted proposed statutory amendments as early as May 1960, it was not until 1967 that Congress took up the FHLBB's recommendations regarding the

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[12] S. Rep. No. 810, 86th Cong. (1959), *reprinted in* 1959 U.S.C.C.A.N. 2883.

[13] *See* S. Rep. No. 810, *reprinted in* 1959 U.S.C.C.A.N. 2887.

[14] *See* Pub. L. No. 86-374, 86th Cong., 73 Stat. 691-693 (1959). A year later, the Spence Act was made permanent. Pub. L. No. 86-746, 74 Stat. 83 (1960).

comprehensive regulation of savings and loan holding companies.[15] After lengthy hearings and debates, Congress eventually enacted the modern version of the Savings and Loan Holding Company Act ("SLHCA"),[16] which differed markedly from the FHLBB's recommendations with respect to the treatment of unrelated holding company business activities.

The FHLBB was primarily concerned with the supervisory problems raised where the holding company structure was employed to take advantage of subsidiary thrifts and divert their resources to non-thrift activities. Thus, the FHLBB recommended limiting all savings and loan holding companies -- unitary and non-unitary alike -- to five specific thrift-related activities, which, somewhat similar to the FRB's authority at the time, could be augmented by activities administratively found to be a "proper incident to the operation of insured institutions and not detrimental to savings account holders therein." Congress rejected this wholesale approach and confined these restrictions to multiple savings and loan companies only.[17] Because they were thereby entirely exempted from the activities restrictions imposed on multiples, unitary savings and loan holding companies were free to enter into any nonthrift business pursuit.

Congress's decision in 1967 to grant the nonthrift business exemption to unitaries was made purposefully and deliberately. As the Senate Report indicates, Congress sought to encourage the acquisition of single thrifts by companies outside the savings and loan business and to free such acquirers from the activities limitations applicable to multiple holding companies. Contrary to the Congressional attitude towards bank holding companies, there were no serious concerns over the combination of single thrift institutions and other commercial enterprises under common control. The Senate Report explains:

> There were arguments advanced that the definition of a holding company should be amended to apply only to those companies which control two or more associations. This would enable the owners of stock associations to sell the association to a corporate entity not in the savings and loan business.
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> The committee felt, however, that a complete exemption for all holding companies with one association would not provide the [FHLBB] with adequate supervisory authority. . .
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> In order to provide the [FHLBB] with adequate authority while at the same time alleviating the marketability problem for existing stock associations, the committee recommended that holding companies which control only one

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15 S. 1542 and H.R. 8696, 90th Cong. (1967).

16 Savings and Loan Holding Company Amendments of 1967, Pub. L. No. 90-255, 82 Stat. 5 (1968).

17 *See* Pub. L. No. 90-255, 82 Stat. 8 (1968)

> association be exempt only from the unrelated activities and divestment provisions of section 408(c). This would permit the sale of a stock association to a corporation (provided the corporation controlled no other associations) but at the same time will provide the [FHLBB] with the examination, registration, and reporting authority it needs. . .
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> In adopting such an amendment, the committee also recommends that the [FHLBB] approve, under statutory standards, all sales of savings and loan associations to companies not in the savings and loan business. This will insure that the assets of an association will not be jeopardized by transferring control of the association to interests inimical to the financial integrity of the association.[18]

c. Extension of BHCA of 1956 to One-Bank Holding Companies

In the years immediately after enactment of the 1966 BHCA Amendments, the composition of one-bank holding companies changed drastically. Twenty-three of the 51 banks in the United States with deposits of $1 billion or more, including the six largest in the country, holding over 20 percent of the deposits of the entire banking system, became subsidiaries of one-bank holding companies by 1970.[19] Although no major abuses relating to one-bank holding companies were then detected, Congress determined to address possible future problems posed by the one-bank holding company device:

> In view of the large growth of the assets held by the one-bank holding company industry, and in view of the theoretical freedom of a one-bank holding company to engage in any business, or acquire anything it desires (subject to antitrust laws), the committee is agreed that it is necessary to amend the Bank Holding Company Act to bring one-bank holding companies under the regulation provided by that act.[20]

Accordingly Congress enacted the Bank Holding Company Act Amendments of 1970,[21] a fairly comprehensive revision of the 1956 BHCA that formed the nucleus of the modern version of the BHCA. As the quoted passage suggests, one of the major concerns raised by the growth of one-bank holding companies was their entrance into nonbanking businesses, which contravened the prevailing belief that banking should remain separate from commerce. Many one-bank holding companies engaged in commercial or industrial pursuits that had no

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[18] S. Rep. No. 354, 90th Cong. 6, 7 (1967) (emphasis added).

[19] S. Rep. No. 91-1084, at 3 (1970). "It has been estimated that the percentage of the Nation's total banking deposits which are held by banks controlled by one-bank holding companies has grown from less than 10 percent in early 1967 to more than 40 percent at the present time." *Id.*

[20] S. Rep. No. 91-1084, at 3, 4 (1970).

[21] Pub. L. No. 91-607, 84 Stat. 1760 (1970) ("BHCA Amendments of 1970").

discernible relation to their banking powers. These businesses included television broadcasting, the manufacture of furniture, yarns, carpets, lawnmowers, and shoes, and the operation of department stores, experimental farms, ranches, pizza parlors, and restaurants. The mixture of these operations with commercial banking, was, in the view of the chairman of the House committee, "clearly against the public interest."[22]

Partly in response to the extension of bank holding company regulation to one-bank holding companies and the unexpected development in the unrelated activities of one-bank holding companies, and to add interpretive flexibility (as suggested by the Federal Reserve Board and other Federal regulators), Congress retained the "closely related/proper incident" standards of section 4(c)(8) of the BHCA but added a balancing test that read as follows:

> In determining whether a particular activity is a proper incident to banking or managing or controlling banks the [FRB] shall consider whether its performance by an affiliate of a holding company can reasonably be expected to produce benefits to the public, such as greater convenience, increased competition, or gains in efficiency, that outweigh possible adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interest, or unsound banking practices.[23]

Subsequent FRB application of the revised test in section 4(c)(8) of the BHCA, combined with strict BHCA grandfather rules, generally forced the large one-bank holding companies formed in the late 1960's to divest their nonbanking activities. Despite extensive later amendments to section 4(c)(8) designed primarily to curb bank holding company encroachment into the insurance business and to expedite resolution of the thrift crisis of the late 1980's, the approval standards of section 4(c)(8) have remained unchanged since the BHCA Amendments of 1970.

As a rule, the FRB has not attempted to expand the section 4(c)(8) rules in approving new nonbanking activities for bank holding companies. The FRB's rules regarding bank holding companies are contained in its Regulation Y.[24] In its latest revision to Regulation Y, effective April 21, 1997, the FRB codified a list of fourteen categories of previously approved, permissible nonbanking activities.[25] Various FRB rulings on provisions of the BHCA, including interpretations regarding activities determined closely related to banking can also be found in other provisions in Regulation Y.[26] Regulation Y also contains a list of seven

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22 H.R. Rep. No. 91-387, at 27-30 (1969). (Individual views of Chairman Patman).

23 12 U.S.C. § 1843(c)(8) (West Supp. 1997); *see* S. Rep. No. 91-1084, at 12-16 (1970).

24 12 C.F.R. Part 225.

25 62 Fed. Reg. 9335-38 (Feb. 28, 1997) (to be codified at 12 C.F.R. § 225.28).

26 *See* 12 C.F.R. §§ 225.101-145 (1996).

activities that the FRB has determined are not closely related to banking.[27] There is, of course, nothing in the FRB's regulatory scheme comparable to the unlimited range of nonthrift activities open to properly conducted unitary thrift holding company operations.

d. Post-1968 Developments Affecting the Unrelated Business Activities of Unitary Thrift Holding Companies

The statutory exemption for the unrelated activities of unitary thrift holding companies remained unaffected for fifteen years following its adoption in 1968. During this period, holding company formations accelerated as conversions of associations from the mutual to stock form gradually increased, aided by the ability of Federal associations for the first time to convert to the stock form without relinquishing their Federal charters.[28] With the enactment of the Garn-St Germain Depository Institutions Act of 1982 ("DIA"),[29] the FHLBB was granted the authority to issue de novo Federal stock charters. Thereafter, the stock charter became the preferred form of organization in the savings and loan business and the use of the unitary holding company format grew accordingly.

The DIA, however, also imposed the first statutory condition on unitary thrift holding companies' exemption from unrelated business activities. Where a subsidiary savings association failed to qualify as a domestic building and loan association under the Internal Revenue Code, after a period of three years for compliance, its parent holding company and any of the parent's nonthrift subsidiaries were limited to the activities permitted for multiple holding companies.[30]

Five years later the enactment of the Competitive Equality Banking Act of 1987 ("CEBA")[31] brought the QTL test, a measure of an association's "thriftness." The QTL test is keyed to a percentage of a subsidiary thrift's assets devoted to "qualified thrift investments" ("QTI"). This test performed the same function as the DIA's requirement of qualification as a domestic building and loan association. That is, the subsidiary thrift of a unitary holding

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[27] 12 C.F.R § 225.126 (1996) The list covers (a) insurance premium funding; (b) underwriting life insurance not sold in connection with a credit transaction, (c) real estate brokerage; (d) land development; (e) real estate syndication, (f) management consulting (*but see* new 12 C.F.R § 225.28(b)(9)); and (g) property management.

[28] Pub. L. 93-100, § 4, 87 Stat. 343 (1973) (adding new subsection (j) to section 403 of the National Housing Act ("NHA") (12 U.S.C. § 1725) providing for approval of a small number of study conversion applications) and Pub. L No 93-495, Title I, § 105(d), 88 Stat. 1504 (1974) (adding paragraphs 3-6 to subsection (j) of section 403 of the NHA to provide broader approval authority).

[29] Pub. L. No. 97-320, 96 Stat. 1469 (1982).

[30] Pub. L. No. 97-320, § 335, 96 Stat. 1505 (1982).

[31] Pub. L. 100-86, 101 Stat. 552 (1987).

company was required to meet the test; otherwise, the holding company would be treated essentially as a bank holding company. Under the CEBA QTL test, QTI are defined generally to include residential real estate loans and other housing related investments.[32] Largely prompted by the rapid expansion in powers of both state and federally chartered savings institutions in the early 1980s, the QTL test was intended partially to complement companion CEBA provisions aimed at closing the so-called "nonbank bank" loophole in the BHCA.[33]

The QTL test was further refined by the Financial Institutions Reform, Recovery and Enforcement Act of 1989, ("FIRREA"),[34] which also moved the statutory location of the SLHCA from Title IV of the NHA, major portions of which were repealed, into a new Section 10 of the Home Owners' Loan Act ("HOLA").[35] Without discussing the intricacies of the QTL

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[32] *See* Pub. L. 100-86, § 104(c), 101 Stat. 571 (1987). The general rule was that to satisfy QTL 65% of a savings association's assets needed to come within the definition of QTI. Congress expanded the definition of QTI in 1996 as part of the Economic Growth and Paperwork Reduction Act. Under the amendment, credit card, educational, and small business loans were included in QTI. *See* Pub. L. No. 104-208, § 2303(g), 110 Stat. 3009-425 (1996) (codified at 12 U.S.C. § 1467a(m)(4)(C)(ii)(VII)).

[33] *See* S. Rep. No. 100-19, at 13-15 (1987). The Senate Report described the nonbank bank loophole as follows:

> The nonbank bank loophole arises from the definition of a bank in the Bank Holding Company Act. Under that Act, a bank is defined as an institution that accepts demand deposits <u>and</u> makes commercial loans. A bank that refrains from one of those two activities is not considered a bank for purposes of the Bank Holding Company Act; hence the term nonbank bank.
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> * * * * *
>
> Although nonbank banks continue to be regulated as banks--by the Comptroller of the Currency in the case of national banks and by the State bank supervisors in the case of State-chartered banks--they are exempt from two key provisions of the Bank Holding Company Act. Those are the interstate restrictions in section 3 and the activities restrictions in section 4.
>
> * * * * *
>
> The impetus for nonbank banks stems primarily from large diversified companies wanting to invade the banking business while avoiding the regulatory restraints of the Bank Holding Company Act. Thus some of the nation's largest retailing, securities, and insurance companies have been able to enter the banking business through the nonbank loophole while banks are prevented from entering those businesses by the Bank Holding Company Act.
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> *Id.* at 5, 6 (emphasis in original).

[34] Pub. L. 101-73 (August 9, 1989).

[35] 12 U.S.C. § 1467a *et seq.* Amendments to the HOLA in 1996 broadened the coverage of QTI to include loans for educational purposes, loans to small businesses, and credit card loans. Pub. L. 104-208, § 2303, 110

test, it is sufficient to observe that the penalty imposed on a unitary thrift holding company for the failure of the QTL test by its subsidiary association is mandatory registration and treatment of the parent company as a bank holding company, beginning one year after the failure.[36] For many unitaries, the confinement of their unrelated business activities to those permissible for bank holding companies could have a disastrous impact by causing the forced sale of either the subsidiary thrift or other profitable entities.

Although the effect of a subsidiary thrift's failure of the QTL test on a parent unitary holding company can be quite severe, one significant conclusion can be inferred from requiring compliance with the QTL test. Implicit in the QTL test is a Congressional determination that ownership of a single savings association by a firm engaged in commercial activities does not raise the types of concerns regarding the mixture of banking and commerce and the monopolization, or discriminatory availability, of commercial credit that led to enactment of the BHCA of 1956 and its extension to one-bank holding companies by the BHCA Amendments of 1970.

Recent OTS reports to Congress suggest that the unitary thrift holding company structure has encouraged notable but not overwhelming investment by non-banking firms in home mortgage and consumer lending.[37] Of a total of over 600 unitary holding companies as of June 30, 1977, only 102 unitary companies were actively engaged in nonbanking activities, and these companies together owned 64 thrifts. The range of nonbanking activities by these unitary holding companies varies. Several, but fewer than half, of the 102 companies engage in financial activities such as insurance sales and underwriting, investments, mutual fund management and investor services, and broker-dealer operations.[38] A greater number of unitary holding companies have affiliates that do business in non-financial areas, predominantly real estate and related services. Other non-financial activities of these unitary companies include management services, hotel operations and development, and wood products. In surveying many of these holding companies, OTS discovered that the subsidiary thrift contributes either a minimal amount to holding company revenue (less than 10% in 41% of the cases) or significant amount (over 50% in 56% of the companies surveyed).[39] As these figures show, the OTS experience with holding companies engaged in non-banking activities has been modest. Since the enactment of the savings and loan reform legislation in 1989 and the creation of OTS, unitary thrift holding companies have not as a class presented special

Stat. 3009-425 (1996).

[36] *See* 12 U.S.C. § 1467a(m)(3)(C).

[37] *See* Holding Companies in the Thrift Industry – Background Paper (April 1997); Holding Companies in the Thrift Industry – Supplement to April 1997 Background Paper (January 1998).

[38] *See* Supplemental January 1998 Paper at 25.

[39] *See id.* at 21

supervisory problems.[40]

III. Non-Activity Restraints on Unitary Holding Companies

Although unitary savings and loan holding companies may engage freely in a variety of commercial and financial activities, they do not enjoy free rein to operate the subsidiary savings association solely to maximize the value of the holding company structure. Both Congress and OTS have imposed a variety of requirements, in addition to the QTL test, on unitary (and multiple) holding companies that are designed to protect the safety and soundness of the subsidiary thrift and to enable the subsidiary thrift to perform its core functions.

The existence of a holding company structure presents two kinds of risk for the subsidiary savings association: (i) that the holding company may require the subsidiary to make excessive dividend payments or other transfers; and (ii), less directly, that the holding company may direct the subsidiary to conduct operations in a way that destabilizes the thrift or otherwise detracts from the thrift's lending and other business operations. The restrictions on unitary holding companies cover both kinds of risk.

First, several statutory and regulatory provisions prevent a holding company from directly undermining the capital position of the subsidiary thrift. The thrift itself is subject to capital requirements that OTS has developed (with the other banking agencies) under the so-called "prompt corrective action" provisions of the Federal Deposit Insurance Act.[41] As a general rule, the subsidiary must maintain a total risk-based capital ratio of 8% and Tier 1 risk-based capital and leverage ratios of 4% to remain adequately capitalized.[42] If capital drops below that level, then the holding company must guarantee the thrift's compliance with a capital restoration plan and provide adequate assurances of performance by the thrift.[43] If the holding company fails to provide the appropriate guarantee and assurances of performance, OTS may, among other things, require the holding company to divest itself of the thrift or of certain affiliates that present significant risks to the thrift.[44]

Buttressing this basic requirement of adequate capitalization is the OTS capital distribution rule. This rule, which pre-dates the prompt corrective action provisions, requires

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[40] *See id* at 3-6 (discussing examinations, enforcement actions, and thrift failures); 9-18 (comparisons of thrift subsidiaries of unitary companies with other thrifts)

[41] *See* 12 U.S.C. § 1831o.

[42] *See* 12 U.S.C. § 12 C.F.R. § 565.4(b)(2). In some cases, the leverage ratio may drop to 3% without affecting the thrift's adequately capitalized status.

[43] *See* 12 U.S.C. § 1831o(e)(2)(C); 12 C.F.R. § 565.5(b).

[44] *See* 12 U.S.C. § 1831o(f)(2)(I)(ii), (iii).

OTS approval of any dividend that would cause a thrift to fall below any of its capital requirements.[45] Dividends that would not have cause a capital failure are also subject to limitations based on the thrift's net income.[46] Further, tax sharing agreements between a thrift and its holding companies must conform with several OTS guidelines designed to ensure that the thrift bears its proporational tax liability but not that of the holding company or affiliates.[47]

Second, indirect means by which a holding company might unduly exploit the subsidiary thrift are subject to intensive regulation:

- *Transactions with affiliates.* All thrifts must observe the percentage limitations and arms' length dealing requirements applicable to member banks on transactions with affiliates under sections 23A and 23B of the Federal Reserve Act.[48] Among other things, a thrift's total covered transactions with any one affiliate may not exceed 10% of the thrift's capital stock and surplus, and total covered transactions with all affiliates may not exceed 20% of capital stock and surplus.[49] Such covered transactions must be on terms comparable to those of transactions between non-affiliated entities.[50]

- *No loans to non-banking affiliates.* Section 11(a)(1)(A) of the HOLA prohibits entirely loans or other extensions of credit by a thrift to any affiliates that are engaged in activities that are not permissible for a bank holding company.[51] This prohibition prevents a unitary thrift holding company from using the thrift to fund non-banking activities and enhances the parity between bank and thrift holding companies on transactions with affiliates.

- *Loans to one borrower.* Thrifts are subject to essentially the same limitations as national banks on loans to one borrower, which includes loans to a holding company.[52]

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45 *See* 12 C.F.R. § 563.134(b)(3).

46 *See* 12 C.F.R. § 563.134(b)(1).

47 *See* OTS Regulatory Handbook: Holding Companies § 500, at 88-90 (1993). Unsecured advance tax payments by the thrift to the holding company would be considered unsecured advances in violation of 12 C.F.R. § 563.41(c).

48 *See* 12 U.S.C. § 1468(a).

49 12 U.S.C. § 371-c; *see* 12 C.F.R. § 563.41 (1997).

50 12 U.S.C. § 371c-1; *see* 12 C.F.R. § 563.42 (1997).

51 *See* 12 U.S.C § 1468(a)(1)(A)

52 *See* 12 U.S.C. § 1464(u).

This limitation is 15% of unimpaired capital,[53] which, depending on the circumstances, may be more or less restrictive than the transactions-with-affiliates restrictions discussed above.

- *Anti-tying restrictions.* These restrictions are designed to prevent a holding company from compelling or inducing a customer from doing business solely with the holding company and its subsidiaries by linking products or services of the thrift and an affiliate.[54]

- *Prohibition of evasion of restraints on subsidiary thrifts.* Section 10 of the HOLA prohibits a holding company from undertaking an activity for the purpose of evading the restraints on the activities of the subsidiary thrift.[55]

- *Sales of securities.* Among the abuses of the 1980s was the sale of holding company securities on the premises of the subsidiary thrift. Customers unwittingly transferred amounts from insured deposits to these uninsured investments. OTS has since prohibited these on-premises sales.[56]

- *Serious risk.* The Director of OTS has the authority to impose certain restrictions on a holding company or any of its subsidiaries, if there is reasonable cause to believe that an activity by the holding company or a subsidiary constitutes a serious risk to the financial safety, soundness, or stability of a subsidiary thrift.[57] The Director may restrict dividend payments by the thrift, limit the thrift's transactions with the holding company or affiliate that presents the risk, or restrict any activity of the thrift that might create a serious risk that the liabilities of the holding company and its other affiliates may be imposed on the thrift.[58] The Director also may order termination of the affiliate's activity or divestiture of the affiliate, after notice and opportunity for hearing.[59]

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[53] *See* 12 U.S.C. § 84.

[54] *See* 12 U.S.C. § 1464(q).

[55] *See* 12 U.S.C. § 1467a(c)(1)(A).

[56] *See* 12 C.F.R. § 563.76.

[57] *See* 12 U.S.C. § 1467a(p)(1)

[58] *See id*

[59] *See* 12 U.S.C. § 1467a(g)(5)

IV. Conclusion

Over the past thirty years, the unitary savings and loan holding company structure has served as a vehicle for companies not otherwise engaged in the banking business to establish a financial subsidiary that serves the needs of individual consumers. From the perspective of the thrift, the unitary structure has offered the ability to tap expanded sources of capital. When Congress has expressed concern about possible risks presented by the unitary holding company structure, it has enacted requirements that are appropriately tailored to the public policy at issue. For example, in 1987 Congress sought to ensure that the benefits of unitary status would be available only to those companies that owned institutions that focused on home mortgage lending and accordingly established the qualified thrift lender test. Congress since has expanded the test to include consumer, educational and some small business lending but continues to exclude from unitary status those holding companies that present the perceived risks that the mixing of banking and commerce may create. The 1989 savings and loan reform legislation contained substantial new requirements for the thrift industry in order to prevent a recurrence of the crisis of the mid- and late 1980s. Among the new provisions were enhanced provisions on transactions with affiliates, loans to one borrower, and tying arrangements as well as stronger authority for OTS to take appropriate regulatory or enforcement action against holding companies. OTS' experience with holding companies since that time has been modest, and the thrift industry (as well as the banking industry) has enjoyed unparalleled prosperity. The evidence of the last several years is that the unitary thrift holding company has been one way in which Congress has allowed the provision of financial services to evolve, free from undue government restriction but subject to limitations that protect consumers, depositors, and the insurance fund.

Office of Thrift Supervision
Department of the Treasury
1700 G Street, N.W., Washington, DC 20552 • (202) 906-6590

Ellen Seidman
Director

March 22, 1999

Anthony F. Cole
Staff Director
Committee on Banking and Financial Services
U.S. House of Representatives
Washington, DC 20515-6050

Dear Mr. Cole:

This letter is in response to a question asked by Representative Sue W. Kelly at the February 12, 1999 hearing of the Committee on H.R. 10, the pending financial modernization legislation. She asked whether each member of the panel "would favor a basket approach or for H.R. 10 to remain as it is now without a mix of banking and commerce."

The idea of a commercial basket arises in the context of the debate on whether the new law should permit financial holding companies to engage in a limited amount of commercial activity. Since the savings associations regulated by the Office of Thrift Supervision would not qualify for the commercial basket but would be governed by other provisions in the bill concerning commercial affiliations and activities, we defer on this issue to the agencies directly affected.

Let me take this opportunity, however, to address the related concerns raised about the fact that a thrift may be owned by, or affiliated with, any type of commercial firm (these entities are called unitary thrift holding companies (UTHCs)). The reported bill would not permit approval of additional UTHCs pursuant to applications filed after February 28, 1999. Although existing UTHCs may affiliate with commercial firms, what is often overlooked in the debate are the existing statutory and regulatory restrictions under which a thrift and its holding company and affiliates must operate. These restrictions in effect guard against the types of concerns that are at the heart of the concern with mixing traditional commercial banking activities and commerce. Pursuant to these restrictions:

- A thrift may not make any loan or other extension of credit to an affiliate unless the affiliate is engaged only in activities permissible for a bank holding company (commercial activities are among those that are not permissible). This bar on affiliate commercial lending by a thrift is in addition to the affiliate transaction restrictions of sections 23A and 23B of the Federal Reserve Act, which also apply to thrifts.

- By statute, the thrift charter limits a thrift's commercial lending to 10 percent of assets, with an additional 10 percent of assets permissible for small business lending. A thrift must also meet the qualified thrift lender (QTL) test by holding 65 percent of its assets in residential mortgages, mortgage-related investments, small business loans, and certain other consumer loans. These provisions constrain a thrift's ability to engage in traditional commercial bank lending activities.

- OTS rules also limit the amount a thrift may pay in dividends to its parent holding company. If a thrift's capital levels fall below required levels, it is subject to increasingly stringent restrictions on activities, dividends, and growth.

- Statutory anti-tying provisions prohibit a thrift from conditioning extensions of credit or the furnishing of services to customers by requiring them to obtain other services from an affiliate of the thrift. This addresses the unfair use of market power to coerce banking consumers into purchasing non-banking products and services, which, in turn, unfairly disadvantages competitors.

As I noted in my testimony before the Committee on February 12, 1999, the unitary thrift holding company structure "permits affiliations of insured depository institutions with insurance, securities and other firms, but with built-in safeguards to avoid undue risks to the taxpayer and to meet the needs of consumers and communities. Based on our experience, there is no reason to believe that affiliations permitted in the unitary thrift holding company structure are inherently risky and should be constrained."

Sincerely,

Ellen Seidman
Director

TESTIMONY OF

HARVEY J. GOLDSCHMID, GENERAL COUNSEL
U.S. SECURITIES AND EXCHANGE COMMISSION

CONCERNING H.R. 10,
THE "FINANCIAL SERVICES ACT OF 1999"

BEFORE THE COMMITTEE ON
BANKING AND FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

FEBRUARY 12, 1999

U. S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

TESTIMONY OF
HARVEY J. GOLDSCHMID, GENERAL COUNSEL
U.S. SECURITIES AND EXCHANGE COMMISSION

CONCERNING H.R. 10, THE "FINANCIAL SERVICES ACT OF 1999"
BEFORE THE COMMITTEE ON BANKING AND FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

February 12, 1999

Chairman Leach, Representative LaFalce, and Members of the Committee:

My name is Harvey Goldschmid, and I am General Counsel of the Securities and Exchange Commission (the "Commission" or "SEC"). I appreciate the opportunity to present testimony on behalf of the Commission regarding H.R. 10, the "Financial Services Act of 1999." On behalf of the Commission, I commend you, Chairman Leach and members of the Committee, for continuing your efforts to modernize the structure for regulation of the financial services industry.

I. Overview

The Commission has long supported the primary goal of H.R. 10 -- modernizing the legal framework governing financial services.

For this reason, the Commission and its staff worked with Congress last year to craft legislation that would modernize the legal structure for financial services while at the same time preserve principles that are fundamental to effective oversight of the U.S. securities

markets. Our securities markets today are strong, vibrant, and healthy. They are relied on by both individual investors who are increasingly putting their savings in stocks, bonds, and mutual funds[1] and by American businesses that need to raise capital.[2] The success of our securities markets is based on the high level of public confidence inspired by a strong system of investor protection, and on the entrepreneurial and innovative efforts of securities firms. As the nation's primary securities regulator, it is critical that the Commission be able to continue to fulfill its mandate of investor protection and to safeguard the integrity, fairness, transparency, and liquidity of U.S. securities markets.

Last year, although the Commission had reservations, it supported the version of H.R. 10 that was passed by the full House of Representatives in May 1998. However, with regret, I must firmly state that continued negotiations after that point substantially eroded the basic principles that the Commission believes are critical to maintaining securities markets that are strong, vibrant, and healthy. The Commission, therefore, cannot support the version of H.R. 10, which was pending at the end of the last Congress, that the House Banking Committee is now considering.

As the Commission has testified before, its support of a financial modernization bill was contingent on maintaining the "delicate balance inherent in [the House version of]

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1 As of December 1998, mutual fund assets totaled $5.5 trillion. Investment Company Institute, Trends in Mutual Fund Investing: December 1998 (Jan. 28, 1999).

2 In 1998, businesses raised a record $1.8 trillion from investors, $1.31 trillion in 1997, and $967 billion in 1996. (These figures include firm commitment public offerings and private placements and do not include best efforts underwritings.) Securities Data Corporation.

H.R. 10."[3] Unfortunately, the draft of H.R. 10 currently before the Committee no longer represents that balance. H.R. 10 now creates too many loopholes -- too many products are carved out, and too many activities are exempted -- in securities regulation. These loopholes would prevent the Commission from effectively monitoring and protecting U.S. markets and investors. Moreover, the scope of those loopholes, which are ambiguously drafted, may create even greater problems and uncertainties in the future. The Commission cannot ensure the integrity of U.S. markets if it is only able to supervise a portion of the participants in those markets. Neither can it ensure fair and orderly markets if market participants operate by different rules and investors receive different levels of protection.

Rather than attempting to comment on each of the specific provisions of H.R. 10, perhaps it would be more useful, at this time, to step back and outline the broader points the Commission feels should be addressed by any financial modernization bill. Specifically, it is crucial that the Commission retain supervisory and regulatory authority over the U.S. securities markets, regardless of where securities activities are conducted, and continue to determine how those activities are defined.

With that goal in mind, the Commission would like to work with this Committee and the Congress to include the following critical safeguards in any financial modernization legislation:

- Maintain aggressive SEC policing and oversight of all securities activities;

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3 Testimony of Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, Concerning H.R. 10, the "Financial Services Act of 1998," Before the Senate Comm. on Banking, Housing, and Urban Affairs (June 25, 1998), at 2.

- Safeguard customers and markets by enabling the SEC to set net capital rules for all securities businesses;
- Protect investors by applying the SEC sales practice rules to all securities activities;
- Protect mutual fund investors with uniform adviser regulations and conflict-of-interest rules; and
- Enhance global competitiveness through voluntary broker-dealer holding companies.

These objectives are not novel; they have been central themes to all of the Commission's testimony to date. The Commission is eager to work with this Congress to achieve an appropriate balance in H.R. 10, without compromising these important principles. The Chairman and the Commission have directed me and my staff to be at your disposal to discuss these objectives further as you consider financial modernization legislation.

II. Background on the Securities Activities of the Banking Industry

Before discussing the Commission's objectives in detail, I would like to summarize the key points that the Commission has consistently raised in considering Glass-Steagall reform.

The Commission has been the nation's primary securities regulator for 65 years. As such, it is the most experienced and best equipped to regulate securities activities, regardless of who conducts those activities. The Commission's statutory mandate focuses on investor protection, the maintenance of fair and orderly markets, and full disclosure. Moreover, securities regulation encourages innovation on the part of securities firms, subject to securities capital requirements that are tailored to support any risk-taking activities. Significantly, securities regulation -- unlike banking regulation -- does not protect broker-dealers from failure. It relies on market discipline, rather than a federal safety net, with an additional capital cushion and customer segregation requirements to insulate customers and the markets

from the losses of broker-dealer firms. Moreover, protection of customer funds has been further assured by the Securities Investor Protection Corporation ("SIPC").[4]

This Committee is well aware of the many securities activities in which the banking industry now engages. While these market developments have provided banks with greater flexibility and new areas for innovation, they have also left U.S. markets and investors potentially at risk. Because banks have, to date, retained their exemptions from most federal securities laws, their securities activities have been governed in a hodge-podge manner by banking statutes and regulations that have not kept pace with market practices or needs for investor protection. As you know, banking regulation properly focuses on preserving the safety and soundness of banking institutions and their deposits, and preventing the failure of banks. But, because market integrity and investor protection are not principal concerns of banking regulation, the Commission believes that banking regulation is not an adequate substitute for securities regulation.

In order for banks to be fully liberated from the outdated Glass-Steagall Act restrictions on their ability to conduct securities activities, banks must be willing to take on the responsibility for full compliance with U.S. securities laws, with which all other securities

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[4] SIPC is a non-profit membership corporation created by the Securities Investor Protection Act of 1970. SIPC membership is required of nearly all registered broker-dealers, and SIPC is funded by annual assessments on its members. If a broker-dealer were to fail and have insufficient assets to satisfy the claims of its customers, SIPC funds would be used to pay the broker-dealer's customers (up to $100,000 in cash, and $500,000 in total claims, per customer).

market participants must comply. In terms of sound public policy, this Committee should impose such full responsibility on banks.

III. Commission Objectives for Financial Modernization

I will now turn to a more detailed discussion of the fundamental securities principles that the Commission believes are necessary elements of a truly effective financial modernization bill.

A. Aggressive SEC Policing and Oversight of All Securities Activities

Public confidence ir our securities markets hinges on their integrity. As the Supreme Court recently stated: "an animating purpose of the Exchange Act . . . [is] to insure honest securities markets and thereby promote investor confidence."[5] The Commission has an active enforcement division, whose first priority is to investigate and prosecute securities fraud. The banking regulators, on the other hand, are required to focus their efforts on protecting the safety and soundness of banks, which does not consider the interests of defrauded investors. As a former Commission Chairman said in recent Congressional testimony, detecting securities fraud is a full-time job, and it is a far cry from formulating monetary policy.[6]

To continue its effective policing and oversight of the markets, the Commission must be able to monitor all securities activities through regular examinations and inspections, which

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5 United States v. O'Hagan, 521 U.S. 642, 117 S.Ct. 2199, 2210 (1997).

6 See Testimony of Richard C. Breeden, President, Richard C. Breeden & Co., Before the Subcomm. on Finance and Hazardous Materials, House Comm. on Commerce (May 14, 1997).

includes access to all books and records involving securities activities. This is currently not the case. For example, during recent examinations of bank mutual funds, Commission examiners have had difficulty gaining access to key documents concerning the securities advisory activities of banks.[7] The Commission cannot vigorously protect the integrity of U.S. markets and adequately protect investors with one hand tied behind its back.

B. SEC Financial Responsibility Rules for All Securities Businesses

Securities positions can be highly volatile. The Commission's capital requirements recognize this fact and are, with respect to protection from market risk, more rigorous than those imposed by bank regulators. Market exposures and volatility are risks that the net capital rule was designed to address, unlike bank capital requirements, which focus more on credit exposure. Thus, the Commission's net capital rule better protects the liquidity of any entity engaging in often volatile securities transactions.

In addition to promoting firm liquidity, the Commission's net capital rule is a critical tool to protect investors and securities markets because the Commission also uses the net capital rule to address abusive or problematic practices in the market. For example, with

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[7] The Commission and the federal bank regulatory agencies have worked to enhance coordination of their examination and inspection programs. See Testimony of Lori Richards, Director, Office of Compliance Inspections and Examinations, U.S. Securities and Exchange Commission, Concerning the Securities and Exchange Commission's Examination Oversight of Securities Firms Affiliated with Banks, Before the Subcomm. on Financial Institutions and Consumer Credit, House Comm. on Banking and Financial Services (Oct. 8, 1997). Despite these initiatives, however, the Commission continues to have difficulty obtaining access to all appropriate books and records.

respect to penny stock market makers, the Commission can limit their activity by raising capital requirements for market-making activities. In addition, the Commission can expand on the margin rules with respect to particularly risky stocks by increasing capital charges. Finally, the net capital rule's 100-percent capital charge for illiquid securities serves to constrain the market for securities that have no liquidity or transparency. Without the ability to uniformly apply its net capital rule, the Commission's ability to oversee and influence U.S. securities markets is severely inhibited.

In addition to detailed net capital requirements that require broker-dealers to set aside additional capital for their securities positions, the Commission's customer segregation rule prohibits the commingling of customer assets with firm assets. Thus, customer funds and securities are segregated from firm assets and are well-insulated from any potential losses that may occur due to a broker-dealer's proprietary activities.

Because the Commission's financial responsibility requirements are so effective at insulating customers from the risk-taking activities of broker-dealers, the back-up protection provided by SIPC is seldomly used. Although there have been broker-dealer failures, there have been no significant draws on SIPC, and there have been no draws on public funds. In fact, because of the few number of draws on SIPC funds, SIPC has been able to satisfy the claims of broker-dealer customers solely from its interest earnings and has never had to use its member firm assessments to protect customers. This is in sharp contrast to the many, often extensive, draws on the bank insurance funds to protect depositors in failed banks. In addition, during recent market turmoil in the financial markets, SEC-regulated entities were well-collateralized and none was ever at risk of failure.

We must continue to protect our markets from systemic risk by ensuring that there is enough capital to support the market risk that is inherent in securities transactions. In addition, we must ensure that customer funds and securities are fully protected by enforceable requirements to segregate customer assets from firm assets. To satisfy its quest for effective financial modernization, Congress should permit the Commission to set financial responsibility requirements for all securities activities, in order to better protect investors and U.S. markets.

C. SEC Sales Practice Rules Applied to All Securities Activities

All investors deserve the same protections regardless of where they choose to purchase their securities. Unfortunately, gaps in the current bifurcated regulatory scheme leave investors at risk. For example, broker-dealers are subject to a number of key enforceable requirements to which banks are not, including requirements to:

- recommend only suitable investments;
- arbitrate disputes with customers;
- ensure that only fully licensed and qualified personnel sell securities to customers;
- disclose to investors, through the NASD, the disciplinary history of employees; and
- adequately supervise all employees.[8]

Investors are generally not aware of these gaps in regulation and the risks that such gaps create.

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8 The federal bank regulatory agencies have issued guidelines that address some bank sales practice issues. See Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, and Office of Thrift Supervision, "Interagency Statement on Retail Sales of Nondeposit Investment Products" (Feb. 15, 1994). These guidelines are advisory and therefore not legally binding, and they may not be legally enforceable by bank regulators.

In addition, federal banking statutes do not provide customers a private right of action for meritorious claims, and banking regulators do not routinely fully disclose the details of any and all enforcement and disciplinary actions against banks to put customers on alert. Although some customer protections have been suggested by the bank regulators, they are less comprehensive than the federal securities laws and serve to perpetuate the disparities between the bank and securities regulatory schemes.

Some have suggested a system of parallel securities regulation by the banking regulators. However, the Commission notes that the 12(i) model for regulation of bank issuer reporting has not achieved the objectives of the federal securities laws. Under section 12(i) of the Securities Exchange Act,[9] banking regulators are required to adopt rules "substantially similar" to the Commission's rules within 60 days after the Commission's publication of its final rules. Notably, one commentator has stated that "final action by the [banking] regulators in promulgating 'substantially similar' 1934 Act rules has been delayed in some cases over five years after pertinent SEC amendments have been issued."[10] In addition, the 12(i) model perpetuates a complex scheme of disparate rules offering different protections for investors and markets and different levels of enforcement efforts.

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9 15 U.S.C. 78l(i).

10 Michael P. Malloy, The 12(i)'ed Monster: Administration of the Securities Exchange Act of 1934 by the Federal Bank Regulatory Agencies, 19 Hofstra L. Rev. 269, 285 (1990).

I would like to briefly discuss two recent Commission enforcement actions that highlight the need for more universal application of strict sales practices rules to all entities engaged in securities activities.

In the first case, the Commission is alleging that the portfolio manager of two money market mutual funds sponsored by a bank (i) caused the funds to purchase volatile derivative instruments, (ii) fraudulently transferred the derivatives at inflated values between the mutual funds to some of the bank's various trust accounts to cover up the mutual funds' losses, and (iii) ultimately caused the funds to "break the buck." The Commission investigated and has initiated enforcement action against the mutual fund's portfolio manager.[11] However, because of the current bank exemptions from federal securities law, the Commission was unable to bring charges against the bank or its personnel for failing to adequately supervise the fund manager. Under these facts, the Commission ordinarily would have brought charges against any of its regulated entities for similar misconduct, and the Commission considers its ability to bring "failure to supervise" claims to be critical to investor protection. Securities fraud of this type -- where transactions occur both in mutual funds and in bank trust accounts -- illustrates the need for securities regulators to have access to books and records involving all securities activities conducted by banks.

In the second case, employees of a bank and its broker-dealer affiliate blurred the distinction between the two entities and their respective products during sales presentations to

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[11] See In the Matter of Michael P. Traba, File No. 3-9788, Release No. 33-7617 (Dec. 10, 1998).

customers and in marketing materials.[12] In addition, the broker-dealer's employees mischaracterized certain products as conservative investments when, in fact, they were highly leveraged funds that invested in interest-rate-sensitive derivatives. These actions resulted in customers, many of whom were elderly and thought they were purchasing investments in stable government bond funds, making unsuitable purchases of high-risk funds. The case is also evidence of how partial securities regulation split between banks and their securities affiliates is inadequate to fully protect investors.

The Commission believes that the protections provided by the high, uniform standard of the federal securities laws should benefit all investors purchasing securities.

D. Uniform Mutual Fund Adviser Regulation and Conflict-of-Interest Rules

Mutual fund investors should always receive the protection of the federal securities laws. Accordingly, all parties that provide investment advice to mutual funds should be subject to the same oversight, including Commission inspections and examinations. In addition, any type of entity that is affiliated with a mutual fund should be subject to the strict conflict-of-interest provisions of the federal securities laws. For these reasons, the Commission supports what appear to be non-controversial provisions of H.R. 10 that would address the increasing involvement of banks in the mutual fund business and reduce potential conflicts of interest.

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12 In the Matter of NationsSecurities and NationsBank, N.A., Release No. 33-7532 (May 4, 1998).

Banks that act as investment advisers currently enjoy an exemption from the registration and other requirements of the Investment Advisers Act of 1940. As a result, bank investment advisers are not subject to the substantive requirements applicable to registered investment advisers, including: (i) regulation of advertising, solicitation, and receipt of performance fees; (ii) procedures to prevent misuse of non-public information; (iii) books and records and employee supervision requirements; and (iv) the general anti-fraud provisions.

In addition, as banks increasingly advise mutual funds, the Commission grows more concerned that its examiners do not have ready access to information regarding bank advisory activities that could affect bank-advised mutual funds. Such access is necessary in order to detect front-running, abusive trading by portfolio managers, and conflicts of interest (involving, for example, soft-dollar arrangements, allocation of orders, and personal securities transactions by fund managers). For example, as part of its review for conflicts of interest with respect to a bank mutual fund adviser's activities, Commission examiners must be able to compare trading activity in a mutual fund portfolio to that in the bank's trust accounts. As discussed above, the Commission has had difficulty obtaining full access to all relevant information when reviewing the securities activities of banks that advise mutual funds.[13] The Commission must be able to review records relating to all securities activities relating to mutual fund advisers, just as it does for non-bank fund advisers.

The Commission is also concerned about the unique conflicts of interest resulting from increased bank involvement in the mutual fund business. Currently, the Investment Company

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13 See note 7 and accompanying text above.

Act of 1940 places restrictions on certain transactions between investment companies and their affiliates. These restrictions were crafted, however, at a time when Congress could not have anticipated the dramatic change in the scope of bank securities activities. Specifically, the Commission is concerned about conflicts of interest that may arise from:

- bank lending to affiliated mutual funds, possibly on unfavorable terms, to the detriment of fund investors;
- bank holding company personnel serving on the boards of directors of affiliated mutual funds;
- personnel of an entity that lends to, or distributes shares of, a mutual fund also serving on the fund's board; and
- bank trust departments that hold shares in an affiliated mutual fund in a trustee or fiduciary capacity and that have the power to vote such shares.

Legislation that targets such conflicts of interest is necessary. Banks that lend to, advise, and/or sell mutual funds should be subject to rules governing conflicts of interest that arise when banks act in multiple capacities.

E. Voluntary Broker-Dealer Holding Companies

In order to expand overseas, U.S. broker-dealer firms generally must demonstrate to foreign regulators that they are subject to comprehensive supervision on a worldwide basis. Thus, the Commission strongly supports the ability of U.S. broker-dealers to voluntarily subject their activities to Commission supervision on a holding company basis. The Commission's "umbrella" oversight would be based on a risk-supervision model that more appropriately reflects the predominant risk-taking securities activities of the consolidated entity. Of course, any regulated subsidiaries of a broker-dealer holding company would continue to be regulated by the appropriate statutory regulator.

The Commission believes that a supervisory framework for holding companies substantially engaged in securities activities would permit securities firms the flexibility to innovate and keep pace with the rapid changes in today's capital markets. This structure would impose risk-based supervision, consistent with the firm's principal business, and would help protect market integrity by ensuring that there are no supervisory gaps.

IV. Conclusions

The Commission has testified many times during the past decade in support of financial modernization.[14] However, H.R. 10 as currently drafted provides for a labyrinth of

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[14] See, e.g., Testimony of Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, Concerning H.R. 10, The "Financial Services Act of 1998," Before the Senate Comm. on Banking, Housing, and Urban Affairs (June 25, 1998); Testimony of Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, Concerning Financial Modernization and H.R. 10, the "Financial Services Competition Act of 1997," Before the Subcomm. on Finance and Hazardous Materials of the House Comm. on Commerce (July 17, 1997); Testimony of Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, Concerning Financial Modernization, Before House Comm. on Banking and Financial Services (May 22, 1997); Testimony of Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, Regarding H.R. 1062, the "Financial Services Competitiveness Act of 1995," Before the Subcomm. on Telecommunications and Finance and the Subcomm. on Commerce, Trade and Hazardous Materials of the House Comm. on Commerce (June 6, 1995); Testimony of Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, Concerning the "Financial Services Competitiveness Act of 1995" and Related Issues, Before the House Comm. on Banking and Financial Services (Mar. 15, 1995); Testimony of Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, Concerning H.R. 3447 and Related Functional Regulation Issues, Before the Subcomm. on Telecommunications and Finance of the House Comm. on Energy and Commerce (Apr. 14, 1994); Testimony of Richard C. Breeden, Chairman, U.S. Securities and Exchange Commission, Concerning Financial Services Modernization, Before the Subcomm. on Telecommunications and Finance of the House Comm. on Energy and Commerce (July 11, 1990); Memorandum of the Securities and Exchange Commission (under Chairman David Ruder) to the Subcomm. on Telecommunications and Finance of the House Comm. on Energy and Commerce, Concerning Financial
(continued)

complicated, technical exemptions from federal securities law regulation -- the loopholes in the regulatory scheme are now larger than the scheme itself; this could dramatically undermine market integrity. Furthermore, as a practical matter, H.R. 10's securities exemptions have become so complex that it would be a "compliance nightmare" for banks to implement and for the Commission to monitor.

In the debates surrounding this issue, the Commission's primary concerns have been the protection of the integrity of U.S. markets and those who invest in them. Unfortunately, H.R. 10 as currently drafted would prevent the Commission from effectively carrying out its statutory mandates, and the Commission therefore cannot support the bill. However, the Commission supports the effort to advance this process and is eager to continue to work with Congress on these issues.

The Commission encourages all involved to step back and look at the securities issues arising out of financial modernization with a fresh perspective. We must not lose sight of basic securities law protections and goals, which have served to ensure that the U.S. markets are the fairest, safest, most vibrant, most transparent, and most liquid markets in the world.

We thank you for offering the Commission the opportunity to appear here today. I would be happy to answer questions that you may have.

Services Deregulation and Repeal of the Glass-Steagall Act (Apr. 11, 1988); Testimony of David S. Ruder, Chairman, U.S. Securities and Exchange Commission, Concerning the Structure and Regulation of the Financial Services Industry, Before the Subcomm. on Telecommunications and Finance of the House Comm. on Energy and Commerce (Oct. 5, 1987).

Securities Regulation Loopholes in The Financial Services Act of 1999

This outline summarizes the key loopholes in functional regulation contained in the current version of H.R. 10. As the Commission has testified in hearings before the House Banking Committee, the current version of H.R. 10 contains loopholes that would prevent the Commission from effectively monitoring and protecting U.S. markets and investors. The loopholes summarized below do not represent an exclusive list; rather, we are focusing on examples that are particularly egregious. All of the loopholes are contained in sections 201 and 202 of H.R. 10 -- these provisions repeal the bank exemptions to the securities law definition of "broker" and "dealer", subject to numerous exceptions.

- **Excessive Exemptions from Functional Regulation.**

  - The Financial Services Act of 1999 (H.R. 10) misses the mark when it comes to functional regulation. Functional regulation means that companies that buy and sell securities either as broker, for a commission or wrap fee, or as dealer, from inventory or for a mark-up, are regulated under the federal securities laws. H.R. 10, however, has too many exceptions from the definitions of broker and dealer.

- **Trust Activities & Stock Purchase Plans Loopholes.**

  - The trust activities loophole permits a bank to execute securities transactions in a wide variety of agency capacities through any department that is regularly examined for compliance with fiduciary principles and standards, provided the bank is *primarily* compensated on the basis of an annual fee, an assets-under-management fee, an order processing fee, or a flat or capped per order processing fee that does not exceed its execution costs. Additionally, all fees must be consistent with fiduciary principles and standards.

  - The only true limit on a bank's brokerage activities is that they be "consistent with fiduciary principles." However, many protections afforded to investors under fiduciary law can be varied by contract. For example, contracts may be used to substantially dilute conflict of interest requirements commonly associated with fiduciary concepts.

  - The language of this loophole goes well beyond traditional trust activities where a bank acts as a bona fide trustee. This exception is so broad that it would allow a bank to operate — totally outside the protections of the federal securities laws — an entire brokerage firm out of its trust department.

- H.R. 10 also permits a bank to effect transactions in employee benefit plans, dividend reinvestment plans, and issuer plans ("Stock Purchase Plans"), provided the bank's compensation consists *primarily* of administrative fees, or flat or capped per order processing fees.

- Since under both the trust activities and Stock Purchase Plan loopholes, banks only have to be *primarily* compensated on the basis of an annual fee, an assets-under-management fee, an order processing fee, or a flat or capped per order processing fee, a bank with a large asset management fee would still be able to charge commissions. This would give the bank a salesman's stake in the transactions it effects without being subject to the investor protection requirements of the federal securities laws.

- **Private Placement Loophole.**

  - H.R. 10 permits a bank to conduct private placement activities if after one year of enactment of H.R. 10 the bank is not affiliated with a registered broker-dealer that engages in dealing, market making or underwriting activities with respect to non-exempt securities.

  - Because private placements are exempt from many of the registration and disclosure requirements of the federal securities laws, investors are in greater need of assurance that the intermediary (whether it be a bank or broker-dealer) is subject to all other securities law protections.

  - The types of investors that qualify for private placements are not necessarily so sophisticated as to not require sales practice protections. (e.g. Gibson Greetings, and purchasers of limited partnerships). Furthermore, even if the investors are so sophisticated as to truly not rely on the same level of suitability and sales practice protections of the federal securities laws, such investors do need other protections — e.g., capital requirements to ensure that their counterparties are liquid and can stand behind all trades and an aggressive enforcement process in case there is fraud.

  - The private placement market has grown considerably and constitutes a large percentage of the total amount of securities offerings. In addition, much of the debt market (which has also grown considerably and is now the preferred method of borrowing by many corporations) is privately placed rather than publicly offered.

- **Definition of "Qualified Investor" Loophole.**

  - H.R. 10 permits banks to deal in derivative instruments with individuals who have at least $10 million in investments, and with governmental entities that have at least $50 million in investments.

  - The version of H.R. 10 passed by the House last year narrowly defined qualified investor with respect to derivative instruments to essentially include only institutional investors. This year's version of H.R. 10, however, permits banks to deal in complex and hard-to-value securities products — i.e., derivatives — with a broader class of persons without having to comply with the federal securities laws. This means that a broader class of investors would not have the protections of the federal securities laws. Recent events, however, have underscored that these protections are important to even ostensibly sophisticated investors. The more complex and difficult to understand a security becomes, the greater the need is for the investor protection provisions of the federal securities laws.

  - Derivative instruments, such as option agreements, unlike other financial instruments, inherently contain greater risks to the writer — risk of unlimited losses — and to the purchaser — risks associated with being highly leveraged. Because of these greater risks, the universe of persons with which a bank may deal in derivative instruments without complying with the investor protection provisions of the federal securities laws should be more narrowly tailored. Certain municipalities and the GFOA have stated that even sophisticated investors require the protections of federal securities laws, particularly suitability, with respect to derivatives trading activities. The experiences of Orange County and Long-Term Capital Management shows that "sophistication" provides incomplete protection for investors.

- **New Products Loophole.**

  - With respect to a "new" product offered by a bank that is a security, H.R. 10 provides a process whereby the Commission may determine by rulemaking (after consultation with the Federal Reserve Board) that investor protection concerns warrant requiring activities with respect to such new product be subject to the federal securities laws. H.R. 10 defines a "new" product as anything that is not a "traditional bank product" and that was not subject to Commission regulation as a security.

  - By linking "new" products and "traditional banking products," H.R. 10 permits the banking industry to develop new products that are securities (or slightly modify existing securities products) and receive excepted treatment as if they could be interpreted to come within the definition of "traditional banking

products." This creates a huge loophole in broker-dealer regulation and prevents the Commission from providing the investor protections contained under federal securities law to investors in such "new" products even though they are securities.

- The Commission is not opposed to the rulemaking process nor to judicial review of its rulemaking. However, the Commission is opposed to a provision that would permit the filing of a petition for judicial review to operate as a stay of any Commission action against a bank for failure to register as a broker-dealer.

- While an *aggrieved party's* petition winds its way through the courts, the Commission is prohibited from requiring any bank that engages in transactions in the new product to register as a broker-dealer. Thus, investors in the new product will not have the protections of the federal securities laws.

STATEMENT
OF THE
NATIONAL ASSOCIATION OF INDEPENDENT INSURERS
ON
H.R. 10
FINANCIAL SERVICES ACT OF 1999
BEFORE THE
COMMITTEE ON BANKING AND FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES
FEBRUARY 10, 1999

The National Association of Independent Insurers (NAII), a property/casualty trade association representing more than 600 companies, supports H.R.10, the "Financial Services Act of 1999." We agree that modernization of our financial services system is long overdue and we commend Chairman Leach for scheduling early consideration of this legislation.

Under the McCarran-Ferguson Act of 1945 (15 USC Sec. 1011-1015), the states were granted the authority to regulate the business of insurance. Despite various attempts to rescind or modify this authority in recent years, Congress has chosen to preserve the regulation of insurance activities at the state level. The prevailing competitive climate in the industry again demonstrates the wisdom established over 50 years ago with passage of the McCarran-Ferguson Act. NAII and its members continue to believe that state regulation of insurance is far more effective and produces greater efficiencies within the marketplace than the intervention of federal regulation.

Recognizing the importance of this concept, NAII opposed financial services modernization legislation early in the 105th Congress because it infringed upon state insurance regulation by pre-empting state laws or imposing federal mandates upon state insurance regulation. Eventually, we supported the legislation after changes were adopted that diminished the federal intrusion into state insurance regulation mandated in the bill by providing greater assurances to state regulators that they would regulate bank insurance activities. This is known as "functional regulation." As we know, Congress failed to pass H.R. 10 last year despite the tenacious efforts of Chairman Leach and other leaders on the House Banking Committee.

This year's version of H.R.10 provides for the "functional regulation" of financial activities, thus ensuring that all new entrants into the insurance business will be subject to the same regulatory standards as existing insurance companies. NAII commends Chairman Leach for introducing the bill with this concept preserved. In addition, there are several other components important to NAII and its members contained in H.R. 10. These include provisions requiring insurance underwriting to be conducted through a separate corporate structure thus preserving the separation of insurance and banking functions; defining insurance as those products so regulated by the relevant state insurance regulator as of January 1, 1997; creating a procedure for resolving disputes "without unequal deference" in the U.S. District Court of jurisdiction over

products falling under the insurance definition; providing thirteen safe harbors to protect state insurance regulation within the bounds of the *Barnett Bank* decision; and providing appropriate consumer protections. All of these elements are essential elements in a final proposal for NAII's continued support of financial services modernization.

However, NAII believes that language currently in the bill may upset the delicate balance which the concept of "functional regulation" seeks to achieve.

We believe that the language in Sec. 104(b)(4)(D)(ii) and Sec. 104 (c)(2) may unintentionally establish a loophole through which a bank could avoid state insurance regulation of activities other than sales of insurance. These provisions, as currently drafted, would permit a state insurance regulation to be deemed discriminatory as a matter of law and thus subject to preemption by federal law, even if the regulation was completely neutral in its application and the state regulator had no intention whatsoever of discriminating against banks.

NAII and its members do not believe it was the intention, under the carefully balanced doctrine of "functional regulation" established and solidified by H.R. 10, to permit banks to avoid state insurance regulation of activities where the state regulator had no intention of discriminating against banks. NAII agrees with and supports the proposition that state insurance regulation should be the same for both insurance companies and bank insurance affiliates.

Accordingly, NAII recommends that subsection (b)(4)(D)(ii) be amended by simply adding a sentence at the end of the section as follows:

> "However, this subsection (ii) shall not apply where such impact was not intended by the state and such state action has a legitimate, nondiscriminatory basis."

We also recommend that subsection (c)(2) be amended by adding a similar sentence at the end of the section as follows:

> "However, this subsection (2) shall not apply where such impact was not intended by the state and such state action has a legitimate, nondiscriminatory basis."

NAII submits this language as being consistent with cases under the Civil Rights Act of 1991: *International Brotherhood of Teamsters v. United States 431 U.S. 324, 52 L.Ed. 2d 396, 97 S. Ct. 1843 (1977); Wards Cove Packing Co. v. Atonio, 490 U.S. 642, 104 L. Ed. 2d 733, 109 S. Ct. 2115 (1989), McConico v. Cincinnati Gas & Electric Co., 1997 U.S. App. LEXIS 10786.* In these cases, language permitting rebuttal of the adverse impact claim included "job-related," "consistent with business necessity," and "by articulating a legitimate, nondiscriminatory business reason for acting as it did."

NAII also believes the thrift charter concept should be protected in a final version of financial services modernization legislation. The unitary thrift charter provides a means for insurers to enter the broader financial services market. A number of property/casualty insurance companies have either applied for, or are in the process of applying for, thrift charters. Accordingly, we

believe Title IV of the bill , 'Unitary Savings and Loan Holding Companies,' should be eliminated or amended to properly reflect the current status of these applications.

In sum, NAII and its members have long been champions of free markets and the free enterprise system. Therefore, NAII and those affiliated with the Association are not troubled by the notion of greater competition as banks enter the business of insurance. In fact, many property/casualty insurers are looking at banks as potential business partners that will create new cross-marketing opportunities. Increased competition in insurance markets means consumers will have a greater selection of service providers and the lowest possible prices.

We are apprehensive, however, about regulatory reform of the banking industry if the new regulatory environment permits banks transacting insurance to be governed by special rules or by bank regulators. Insurers, which must operate under state insurance laws and receive oversight from state insurance regulators, will be at a tremendous disadvantage. NAII firmly believes that a restructured bank regulatory system must address this issue in order to avoid unfair competition that could distort or dislocate insurance markets. Preserving "functional regulation" in a final version of H.R. 10 will achieve the goals desired by NAII and its members.

We stand ready to work with Chairman Leach and each member of the House Banking Committee toward this end.

THE BANKERS ROUNDTABLE

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February 9, 1999

Honorable Jim Leach
Chairman
Committee on Banking and Financial Services
U.S. House of Representatives
Washington, D.C. 20515

Dear Chairman Leach:

The Bankers Roundtable is taking this opportunity to present its views on financial law modernization legislation now before the House Banking Committee. The Roundtable represents the nation's major banking companies.

The Bankers Roundtable supports and urges early action on legislation to update our nation's financial laws to enhance the operation of the financial system and to afford customers greater choice and service. In today's market, financial products and services are converging, driven by new technology, new types of products and services and new consumer demands. Reform of the nation's financial laws would permit markets to evolve more rationally to the benefit of consumers.

The Bankers Roundtable supports financial law modernization that permits affiliation of financial services firms through common ownership and avoids discrimination among firms based on ownership or affiliation. Affiliated firms need flexibility in how they are managed and operated, while meeting safety and soundness requirements.

Market Developments

Because information is so central to the business of delivering financial products and services to customers, new information technologies and customer demands are altering the ways in which financial products and services are provided. Technology and evolving consumer preferences in response to technology are powerful forces that are driving rapid, often unpredictable, change in the financial services marketplace.

Customers-- retail and wholesale-- are seeking new and more cost-effective ways to obtain the financial products and services they need. Customers today have to go through three separate distribution systems to receive the advice they seek on banking, securities and insurance products. Financial law modernization would allow affiliated firms to offer all three products through one distribution system and permit customers to decide which of these products is best for them. Better service, greater choice and products provided in a safe and sound manner should be the goals of financial modernization.

The financial services marketplace continues to evolve and the challenge is, and the goal should be, to develop a legal framework that allows the market to develop and at the same time protects the safety and soundness of the financial system. Financial services legislation should not attempt to micro-manage change. It should enhance the role of existing institutions and take advantage of the regulatory structures that have proven themselves in the past.

Affiliation and Nondiscrimination

Two central concepts are part of financial law modernization-- affiliation and nondiscrimination. Affiliation means that companies in the banking, insurance and securities businesses should be permitted to have a common owner. This owner can be an insurance company, a securities firm, a bank or a holding company. Affiliation does not mean that the risks associated with any one of these businesses should be transferred to or assumed by another, and restrictions on the transfer of assets and risk among separate entities, like those imposed by Sections 23A and 23B of the Federal Reserve Act, should be preserved along with the regulatory structures that govern these businesses as separate enterprises. No need exists to reallocate regulatory jurisdiction simply because affiliation is authorized. Issues of regulatory jurisdiction are contentious, but they are the same whether or not the entities involved are affiliated. Affiliation will be beneficial by bringing about diversification, enhanced operating efficiencies and the promise of better customer service, all of which may be achieved without commingling risk or redesigning our regulatory structures.

Affiliation under a common owner would create flexibility for financial service providers to make better use of technology and corporate structures, to meet market needs and customer demands and to better manage and control risk.

Financial service providers need flexibility in how the operate to meet customer demands. Flexibility will not diminish continued strong safety and soundness regulation. It will only streamline operational and product and service rules. The Banking Committee has strengthened the authority of bank regulators while calling for more rational, streamlined supervision in major legislation in 1989, 1991 and 1996. The banking
agencies are committed to streamlining supervision while maintaining their oversight role by relying more on risk- and market-driven approaches to regulation.

The flexibility all financial service providers need to meet customer demands will be attained through less regulation, less litigation and less arbitrary characterization of products and services, permitting greater opportunities to be competitive in creating products to meet customer needs.

The second principle that should guide legislation is nondiscrimination. Banks, insurance companies and securities firms that affiliate should not be discriminated against– directly or indirectly– because they are affiliated. One great value of affiliation is the ability to use existing delivery channels to deliver a broader array of financial services products. Customers want and, in fact, demand better service and greater value at lower costs. Rules to permit nondiscriminatory affiliation permit that to happen, with customers ultimately being the real winners.

Discrimination against one delivery channel in order to promote the competitive position of another is not good public policy. Customers are not well served where such a policy would prevent them from enjoying the benefits of competition and the opportunity to obtain products and services from a wide array of sources with greater convenience and efficiency. Nondiscrimination will assure customer ability to obtain convenient, efficient service and should be a key principle of financial services modernization. Balanced regulation of American financial services providers-- large or small, diversified or single line-- is critical. There should be no room for discrimination, either overt or from a disparate impact, simply because two financial service providers are affiliated with each other.

Additional Goals

Two additional goals of financial law modernization merit attention. First, as the Banking Committee considers legislation in this area it should follow the principle of "Do No Harm." Banks are but one part of the financial services industry, but they

are the part that provides, among other things: (1) community lending and support services, (2) critical lending support to our nation's small businesses, (3) the engine that pulls our economy out of difficult times, and (4) the heart of the nation's payment system. There is an overriding value in having a strong, healthy and vibrant banking system, a system that is integral with the overall structure of a modern financial services industry. New legislation should neither weaken our banks nor diminish the value of a banking charter.

Second, two decisions by the United States Supreme Court have addressed the relationship of federal and state law and the scope of the national bank charter. Those decisions, the products of lengthy litigation over long standing statutory law, provide certainty to the financial services industry and represent an area of the law which is now settled and should be free from further costly litigation. Legislation should not open up this settled area of the law to new litigation.

Consumer Issues

Modernization of our nation's financial laws will produce consumer benefits in the form of new products, stronger companies of all sizes to offer those products, new delivery outlets on the Internet, the mails, television and so on and geographic freedom for consumers to access their services.

To that end, it may be premature to craft new consumer protections at a time when the new products or their delivery systems are unknown. The financial services marketplace should be allowed to evolve before such judgements are made. Regulators have enormous powers individually and collectively to address any practice that is seen as adverse to consumers. In a highly competitive market, serious repercussions come to businesses that are exhibit insensitivity to consumer needs and concerns.

If consumer protections are needed, then the reach of such protections should encompass all providers of such financial services. Consumers should be protected regardless of the delivery channel they choose. Singling out one industry for such regulation just leaves consumers vulnerable when they shop outside that industry. If a consumer protection is necessary for a certain product, then it should exist for that product, not just for one of the institutions that offers the product.

Committee Action

The Roundtable supports legislation that creates a workable framework for market development, affords all competitors the opportunity to compete and avoids discrimination against a given competitor.

The Roundtable supports early action on legislation. H.R. 10 provides a solid framework for moving forward with modernization of our nation's banking laws. Should changes be made to H.R. 10, they may merit support if they improve the bill in keeping with the goals of a level playing field set forth above.

The Roundtable believes it is vital that there be strong support within the committee for a measure reported by the Banking Committee and that there be a bill reported that garners strong support from the financial services community and other affected parties; these will be essential to moving the bill through remaining legislative hurdles.

The Roundtable looks forward to working with the Committee as it proceeds on this important legislation.

Sincerely,

Dick Kovacevich

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